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**ISSUES RELATING TO HIDDEN/UNREPORTED INCOME
AND TAX FRAUD**

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Table of Contents

I.	INTRODUCTION	1
II.	IDENTIFYING HIDDEN AND/OR UNREPORTED INCOME	1
	A. Identifying Hidden Income	1
	B. Identifying Unreported Income	2
	1. <u>Sources and Application of Funds Computations</u>	
	2. <u>Percentage Mark-Up Analysis</u>	
	3. <u>Net Worth Expenditures Methods of Proof</u>	
	4. <u>Bank Deposits Method</u>	
	5. <u>Other Suggestions</u>	
III.	TAX ISSUES AND ALTERNATIVES	3
	A. Tax Issues	3
	B. Alternative Solutions	5
	1. <u>Binding Arbitration</u>	5
	2. <u>File Amended Returns</u>	5
	C. Innocent Spouse Rule	5

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ISSUES RELATING TO HIDDEN/UNREPORTED INCOME AND TAX FRAUD

I. INTRODUCTION

All family law practitioners are confronted on a regular basis with the issue of trying to establish and prove hidden income or unreported income. Although the terms hidden and unreported income are frequently used interchangeably, they are substantially different in both form and consequences.

Hidden income can be expressed as cash inflow to an individual or cash equivalent benefit received by an individual that is not necessarily apparent. It may or may not be reported on income tax returns and even when reported may not be readily identifiable. Some examples of hidden income include the following:

- (1) Pass through entity cash distributions to owners;
- (2) Rental income to an owner of real estate who leases the property to his closely-held business;
- (3) Reimbursed business expenses for automobile use, dining out, business trips that include a personal or vacation component, club dues, education costs, insurance benefits; and
- (4) Where depreciable or depletable property exists, non-cash charges may appear in income tax returns and financial statements substantially reducing actual cash flows.

In contrast to hidden income, the term unreported income consists of cash inflows to an individual that are not reported for financial reporting and/or income tax purposes.

How do these issues arise?

Generally, it results from statements made by a frantic spouse to her lawyer during the initial interview informing the lawyer that "tons of cash" came into the household from the other spouse's business during the marriage or that huge levels of personal expenses will run through the business on personal or business credit cards, or that scrap steel was sold out the back door of the factory for cash or in the case of apartment complex owners, laundry and dryer machine monies were kept and never reported.

In most, but not all instances, the complaining party usually witnessed the money coming in or benefited directly from the cash or credit card.

To the practicing lawyer, identifying and establishing hidden income and/or unreported income are critical when dealing with the following issues in a matrimonial matter:

- (1) Temporary and/or permanent child support;
- (2) Temporary and/or permanent maintenance/alimony; and
- (3) Valuation of assets including closely-held businesses.

In this paper and presentation I will be focusing on the following points:

- (1) How do you prove hidden and/or unreported income?
 - (2) Assuming that you can prove the existence of hidden and/or unreported income, what other issues must be considered before you present this information to the trial court.
 - (3) What is the Innocent Spouse Doctrine and how does it apply to your case.
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II. IDENTIFYING HIDDEN AND/OR UNREPORTED INCOME

A. Identifying Hidden Income

Based upon the definition of this term supplied hereinabove, hidden income is much easier to establish than unreported income.

- (1) Pass through entity cash distributions to owners are identifiable through partnership or sub-s income tax returns, K-1's issued to the taxpayer, the entities general ledger, or cash disbursements journal. The more subtle issue is matching entity distributions to the appropriate tax year of the recipient.

Issues Relating to Hidden/Unreported Income and Tax Fraud

- (2) Advances or loans from a controlled entity to a taxpayer/owner can be identified from various sources including corporate tax returns, K-1's, general ledgers, corporate or partnership cash disbursements journals.
- (3) Real Estate rental income. The cash flow, including the non-cash charge of depreciation, appear on Schedule E of the individual tax return. To determine whether rental rate charged is at "fair market", consult an MAI or broker in the area to determine current market rates.
- (4) During discovery obtain the personal and business credit card monthly statements and purchaser receipts, employee business reimbursement, records and vouchers, and other material. Sit with your client and go through all charge account statements to determine personal charges.

B. Identifying Unreported Income

Consider your objective of finding unreported income of a spouse involved in a divorce with the role of a government agent seeking to find unreported assets or income of a major racketeer, drug lord and/or crooked politician. In this way you can avail yourself some of the indirect methods of discovering such income used by the Internal Revenue Service and other state and federal government agencies. These methods include the following:¹

1. Sources and Application of Funds Computations

This is the most widely used approach to verify reasonableness of stated income. In its simplest terms, undisclosed income is identified if all known applications of funds greatly exceed the known sources of these funds. In other words, if one's expenses are \$25,000 per month and the only known sources of income total \$12,500 per month, then there must be unreported income. Be careful to consider all known sources of cash, including taxable income, loans, advances, gifts, transfers between accounts and other sources. This method is usually the first analysis to be applied to verify your client's allegations of undisclosed income.

2. Percentage Mark-Up Analysis

This is a commonly used method applied to retail businesses. It is used by state agencies to verify sales tax liabilities. The IRS has also used this approach to test gross receipts by extrapolation from purchase records. The mark up in a business is the amount added to the cost of an item for sale. Average mark ups can be determined from several sources:

- (1) Industry Trade Associations;
- (2) Competitors; and
- (3) Company historical records/performance.

3. Net Worth Expenditures Methods of Proof

This technique involves establishing and then comparing assets and liabilities (net worth) at various fixed points in time. Excess income is measured by the level in which net worth has increased during the relevant time periods. The procedure works as follows:

STEP 1. Calculate the value of assets as of a certain date. Assets such as cash and cash equivalents are listed at their value on the selected valuation date. Fixed assets such as real estate, machinery and equipment, coins, stamps, and art are shown at historical cost.

STEP 2. Ascertain the liabilities as of the date certain.

STEP 3. Net worth is ascertained as the difference between assets and liabilities as of the date certain.

STEP 4. Compare the respective net worth calculations. For example, if the beginning net worth (i.e. 1995) is \$100,000 and the net worth in 2001 is \$500,000, and all fixed assets are shown at historical cost, then the assumption made is the \$400,000 increase represents income. Be careful to exclude such non-income items such as gifts or inheritances received between relevant time periods.

¹ See, Use of Indirect Methods to Prove Income, 16 N. 10 Fairshare 2 (1996)

Issues Relating to Hidden/Unreported Income and Tax Fraud

In approving and utilizing the net worth approach, if an individual has more wealth at the end of a period than at the beginning of the period, and non-income items such as inheritance, gifts and loans, do not explain the increase, then the increase is a valid approximation of income earned during the period. Thus, the essential components of a case using this approach are as follows:

- (a) Beginning net worth must be established with reasonable certainty.
- (b) Net worth at the end of the period must be established with equal certainty. The difference between beginning and ending net worth represents the net worth increase and, as stated above, can be considered income.
- (c) A reasonable source of income from which the net worth increase originated must be established. Similarly, the existence of non-taxable sources of income must be considered and deducted.

4. Bank Deposits Method

This technique involves adding up all deposits and credits to all known bank accounts of the subject. Adjustments are made to reflect exchanges or transfers between accounts, non-income deposits such as loans, gifts, proceeds from sale of capital assets, checks issued to cash which may have been used for redeposit and cash on hand at the beginning of the period. If proper adjustments are made, total deposits during the time period selected can be regarded as income.

In summary, the essential elements to prove income using the bank deposit method are:

- (a) Establish that the individual was engaged in a business or income producing activity;
- (b) Periodic and regular deposits of funds were made into the accounts;
- (c) Determine whether a deposit was from an income or non-income source;
- (d) Eliminate all transfers between accounts.

5. Other Suggestions

Assume you are told by a potential or current client that he or she receives hundreds or thousands of dollars in cash to pay household expenses, purchase furniture, art or jewelry, clothes, etc. and there is no immediate need to file a lawsuit. This provides you with a unique opportunity to develop your case.

SUGGESTION: Over a period of several months have your client inventory by serial number and by photograph all monies received as well as all invoices and receipts reflecting the use of the money.

CONFLICT: While this provides you with valuable information useful to establishing your case, you are placing your client in a dangerous position with the IRS. She will not be eligible to claim Innocent Spouse status and will be vulnerable to criminal and civil penalties and interest.

In the remaining portion of this paper and presentation, we will discuss these very sensitive issues and possible alternatives.

III. TAX ISSUES AND ALTERNATIVES

A. Tax Issues

Generally speaking, if you are able to demonstrate early on that there is a potential for provable hidden income or unreported income, you have provided your client with a significant advantage. Your opponent should begin settlement discussions because the last place either party wants to be is before a judge talking about hidden or unreported income. In many jurisdictions the judge will pull both lawyers aside and urge a settlement before testimony is received. At that point, many jurisdictions require the trial judge to automatically inform the IRS.

In some cases, albeit rare, your client, the non-business owning spouse, may be afforded protection under the Innocent Spouse Rule; however, a careful balancing of the cost and benefits of an expectation that the Innocent Spouse Rule will protect your client must be performed prior to exposing your client to potential income tax liability and possibly criminal liability. Certainly, there are means to avoid the issue, but the spouse trying to prove substantial unreported cash income may often find him or herself in an inescapable trap.

Issues Relating to Hidden/Unreported Income and Tax Fraud

Let me give you an example. During the course of discovery you have put together a strong argument supported by documentary evidence of hidden and/or unreported income. You have met with the opposing attorney and his client in an attempt to settle this matter before trial. They refuse to negotiate believing that your client will back down, or they make a low ball offer which your client cannot accept. You and your client decide that you must proceed with the trial. Trial commences and you have been successful in your cross-examination of the business owner and perhaps have convinced the trial court that considerable amounts of hidden or unreported cash exists.

You then proceed to put your client on the witness stand or the other side calls your client for an adverse party examination. Your client may now be in a difficult position and you may have exacerbated the problem. Imagine the following adverse examination of your client:

Q: Your attorney just attempted to establish that your Husband had \$100,000 in unreported cash income during each of the last four years. Is that correct?

A. Yes.

Q. And you agree that your Husband had such income for the past four years, namely, 1997, 1998, 1999 and 2000?

A. Yes.

Q. I refer you now to Exhibits G, H, I & J, which are your joint federal income tax returns for the years 1997-2000. Is that your signature on each of these returns?

A. Yes.

Q. And did you know at the time you were filing these tax returns that your Husband had substantial cash income for the years in question which was not reported on those tax returns?

A. At this point your client has three (3) possible answers: Yes, No, or I am not sure. Let us examine what happens with each possible response.

If she answers, Yes, your client has just admitted that she knew of substantial unreported cash income when she signed the returns. She is now every bit as guilty as her Husband in failing to report it.

If she answers the question by saying, I am not sure, she has contradicted her earlier testimony. Now it becomes clear to the trial court that your client's attempted evasiveness is really lying.

What has been achieved? While you have successfully established the cash income of the business-owning spouse, your client's credibility has been severely damaged, or even worse, she has unwittingly admitted to tax fraud.

Let's discuss the third possible answer, No. In reality, this is probably the most common response. She may say she did not sign the returns or did not review or understand what was on them. Those types of answers will not protect her from further interrogation such as the following:

Q. Okay. So you did not understand what was on the returns. Is that right?

A. Yes.

Q. In 1998, you purchased a new Mercedes automobile outright. Is that correct?

A. Yes.

Q. And it cost \$50,000. Correct?

A. Yes.

Q. You purchased clothing for yourself and the children at Saks Fifth Avenue and Nieman-Marcus, correct?

A. Yes.

Q. Your financial affidavit states you need \$1,500 per month for clothing for yourself and the children, correct?

A. Yes.

Q. And you have no cancelled checks to support those payments, correct?

A. Yes.

Q. During 1997-2000 your children attended private school at a cost of \$15,000 per year per child, correct?

A. Yes.

Issues Relating to Hidden/Unreported Income and Tax Fraud

Q. Is it correct that you and your family took two ski trips every year and one trip to the Caribbean?

A. Yes.

Q. During 1997-2000, is it correct that you had household help and a nanny daily at a cost of \$500.00 per week?

A. Yes.

Q. And isn't it correct that each of these employees were paid by you in cash?

A. Yes.

Q. And you did all of this on the \$25,000-\$45,000 your husband reported on his tax returns? Is that your testimony here today?

Your client has been trapped. She will be viewed as either an incredible witness or a tax criminal. Furthermore, it would be impossible for her to convince anyone that she did not benefit from this unreported income in the years in which joint returns were filed.

Although this section of the paper has focused solely on the spouse of the closely-held business owner, as counsel for the business owner you must carefully admonish your client of the risks inherent in his testifying in a court proceeding. You and he must access the same risks.

In both cases, the ultimate question boils down to "Is it worth it"? Simply put, if you cannot prove or disprove cash income without your client being subject to the interrogation suggested above, can you even have your client testify or even be interrogated by the opposing party regarding these issues.

In many jurisdictions laws exist either in Rules of Judicial Conduct, state statutes, or other similar laws, whereby judges have a duty to report known crimes that come to their attention. While I have only experienced such a reporting on one occasion, it would not be unusual for a judge to report a clear tax fraud to the United States Attorney's Office for prosecution or the assessment of other civil penalties.

Therefore, clients who believe that the isolation of a courtroom with only the parties, lawyers and the judge present, insulates them from tax fraud prosecution are not only naïve, but foolish. Similarly, unwary practitioners should not be fooled into thinking that testimony regarding unreported or underreported income is not a serious matter to be avoided in testimony at all costs. Otherwise, you may find yourself with an unhappy client, an unpaid bill, or even worse, a malpractice claim.

B. Alternative Solutions

1. Binding Arbitration

This may allow a party the opportunity to present his or her case regarding hidden or unreported income without the threat of criminal prosecution. The client must understand the binding nature of this process, i.e., no right to appeal. The respective lawyers should carefully jointly select the arbitrator who should be someone experienced in family law issues.

Binding arbitration alleviates fear of criminal prosecution, potentially saves assets subject to IRS penalties and interest and is an efficient and expedient way to resolve a complex matter.

2. File Amended Returns

C. Innocent Spouse Rule

One safe haven, slight that it is, is the innocent spouse relief provisions pursuant to the Internal Revenue Code. Although the current Innocent Spouse Rule, pursuant to the IRS Restructuring and Reform Act of 1998, added sections which afford greater innocent spouse protection than previously enjoyed, no practitioner should feel safe in letting his or her client testify as to cash income. Given the rules as they stand, together with the fact that there are simply no guarantees that the Innocent Spouse Rule will afford some great degree of protection for the spouse testifying as to unreported cash income, no practitioner should place reliance on such protection when advising his client whether or not to raise the cash issue in a proceeding.

26 U.S.C. §6015 provides special protection for taxpayers who file jointly but are divorced, legally separated or not living together when relief is sought. Pursuant to that provision, innocent spouse relief is available under 26 U.S.C. §6015(b), but additional relief may be available under that provision if no other relief is available. 26 U.S.C. §6015(b) provides "relief from liability applicable to a joint tax filer" when:

Issues Relating to Hidden/Unreported Income and Tax Fraud

- A joint return has been made for the taxable year;
- On that return, there is an understatement of tax attributable to erroneous items of one of the individuals filing the joint return;
- The other individual filing the joint return can establish that when signing the return, he or she did not know and had no reason to know that there was an understatement;
- Taking into account all of the facts and circumstances, it is inequitable to hold the other individual liable for deficiency in tax; and
- The other individual elects the benefits of the innocent spouse protection not later than two years after the secretary of the treasury has begun collection activities with respect to the individual making the election.

Some examination of the Innocent Spouse Rule is necessary. The first two requirements are obvious. There must be a joint income tax return and the understatement of income leading to the deficiency in tax is the fault of one person, not the person claiming the relief. The third requirement, however, is the most troublesome. Under that third requirement, the person claiming the innocent spouse protection must establish that he or she not only did not know, but had no reason to know of the understatement in income. Of course, if the spouse knew, that is the end of the inquiry and such innocent spouse protection is not afforded. However, the spouse claiming the protection cannot hide behind ignorance. One cannot drive a Porsche, wear a Cartier watch, golf daily at the country club, be an international traveler, and claim that he or she did not know that such a lifestyle was impossible on the \$20,000 per year claimed on the income tax return. Under such circumstances, the alleged innocent spouse will be deemed to have reason to know inasmuch as he or she enjoyed the benefit of the underreporting.

Note, however, that under 26 U.S.C. §6015(b)(2), there can be apportionment of relief. If the spouse knew of an understatement of income (for example, due to unreported cash) but did not know the extent of the understatement, he or she can still claim innocent spouse protection to the extent that he or she did not know (or have reason to know) of the full extent of the understatement. In the simplest example, the spouse who knows of the \$2,000 in quarters her husband brings home from the poker machines at his restaurant each week, but did not know of the \$2,000 he was filtering from the cash register each week and depositing into an offshore account, would only be liable to the extent of the unpaid tax due to the poker machine income.

26 U.S.C. §6015 also has provisions to limit liability for taxpayers no longer married or legally separated or not living together. Under 26 U.S.C. §6015(c), an individual can elect innocent spouse protection but has the burden of proof to establish the portion of the deficiency allocable to that individual and then will only be assessed a deficiency for that portion.

Finally, Internal Revenue Code §6015(f) provides equitable relief if the Secretary of the Treasury, ~~after taking into account all facts and circumstances, determines it is inequitable to hold an individual~~ liable for unpaid tax or deficiency. Of course, any practitioner who allows the client to testify as to underreported cash in reliance on the fact that he or she will not be held liable under the general equitable principles of the Internal Revenue Code is making an egregious mistake insofar as there is no strict definition as what would qualify for equitable relief.

In sum, there is some relief for an innocent spouse who did not know or not have reason to know of a tax deficiency. Proving that your client did not know or did not have reason to know of the tax deficiency due to underreported or unreported cash income may, however, be extraordinarily difficult and reliance placed on the innocent spouse provisions of the Code in exposing your client to potential liability is, simply put, unjustifiable.