

*Oh * _\$^#\ _!*, What Do I Tell My Client?*

Chief Justice Roberts began the Supreme Court's May 21 opinion in *Hinck v United States*¹ by observing, "Bad things happen if you fail to pay your taxes when due." After this morning's hastily arranged meeting with the Smiths, with whom you have had sporadic contact over the years, you learn firsthand that the Chief Justice knows of what he speaks. The Smiths received an audit notice for their 2005 return for their S corporation, Honest Services, Inc. ("Honest"). At this point, you are not sure where to go and what to do with the information, but you do need to digest it. First, Honest has been reporting de minimus profits and each of the two shareholders' spouses have only reported \$25,000 per year in compensation. Second, both Honest's and the Smiths' combined taxable income is in the \$300,000 range. That was bad enough, but the part about the offshore bank accounts and paying many of their personal expenditures with credit cards through those bank accounts was quite disheartening. Isn't there something on that Schedule B of the Form 1040 asking about foreign bank accounts? Your clients' descriptions of their lifestyle were not remotely consistent with their reported income over the last several years. **Now What?** The Smiths proposed sending their CPA, Notinformed, from the firm of Don't Ask, Don't Tell, to the initial meeting next week with the IRS Revenue Agent. Notinformed, per the Smiths, would proceed in ignorant bliss of what you learned this morning. One can probably obtain an adjournment of the meeting, but when it does occur, who goes? What do they know? What do they say in response to questions? Another alternative suggested by the clients was to tell Notinformed about some of the problems, have amended corporate and personal returns prepared, and present the auditing agent with the amended returns and a check, a very large check. Do you

immediately involve tax counsel? If so, does a seasoned tax attorney go to the meeting with the IRS?

Some Observations. The above scenario is the classic "eggshell audit." The overriding concern is that it not turn into a criminal investigation. Because of the combination of the federal criminal Sentencing Guidelines and the unique characteristics of applying them to a tax case, on a first offense, each individual could receive a substantial jail sentence. In addition, the IRS has, in each of the past several years, received double-digit funding increases for criminal enforcement from Congress.

Tax counsel would immediately and forcefully advise the taxpayers not to go to the meeting as they will be confronted with questions they are incapable of honestly answering without incriminating themselves. For example, is all the income reflected on the books? Any bogus deductions? (Didn't they say something about problems on the deduction side, too, at the meeting?) The questions you must answer are: Who goes to the meeting? What information are they armed with? What should they say? Most taxpayers' initial inclination is, "I can take care of this. I will meet with the Agent and do the talking." Unfortunately many do. Martha Stewart and Scooter Libby, among others, would caution that misrepresenting facts to a federal agent is a crime that can lead to incarceration, aside from any tax issues. See 18 USC §1001.

If you send an accountant who knows about the problems, then the accountant, even if he or she performs admirably and truthfully (and perhaps declines to answer some questions to aid the truthful part), will likely be an IRS witness at a criminal trial. That is because the tax CPA privilege statute, as shredded as it is, applies to civil tax matters and not to any criminal tax investigation. IRC 7525(a)(2). Should Notinformed and his firm be

retained as counsel's technical assistant under a *Kovel*² letter ASAP to obtain attorney-client privilege protection? If so, then the accountant can be told incriminating information, and it remains privileged even in a criminal investigation.

The first thing that needs to be done is have to a review of the returns by a tax counsel who has privilege for both civil and criminal purposes. One can then assess the nature and the magnitude of the issues and the best multi-tiered defenses. The returns to be reviewed are not only the entity and any affiliates' income and payroll tax returns (remember those cash payments to workers), but also the individuals' Form 1040s. For example, if a Form 1040 discloses gross income of \$50,000, but one then subtracts mortgage interest, property taxes, and other Schedule A deductions, people who are leading a relatively lavish lifestyle are ostensibly doing it on less than \$20,000 of otherwise positive income. The IRS calls this its "Cash T" analysis, and this quick and dirty deed takes but a few minutes and typically reveals much. There better be some inheritances or other tax-free sources of funds. It is our experience that most taxpayers with criminal concerns under the Internal Revenue Code started out years earlier with relatively small scamming, and over time, it grew to absurd proportions.

There is then a plethora of issues aside from who goes to the meeting with the agent (after it has been adjourned once to give time to start to get an understanding of the issues). For example, what is, or is not, Notinformed told? There are always the problems of what to do with any return that is due. If the prior year's returns have not been filed, then they should all be extended, and true and correct returns ultimately and timely filed. Return preparation, even by an attorney, is not privileged. Obviously, for the then current tax year,

accurate corporate books and records must be maintained even though the uninformed client asks, "How do we explain why the business suddenly becomes so profitable?" The answer is the clients themselves can say nothing to an agent that does not spawn a bad situation spiraling out of control. They either are less than truthful or incriminate themselves when asked even general questions such as, "Any skimming?" "Is all income reported on the return?" "Are any employees paid in cash?" etc. Another issue is conflicts of interest. Initially, there is usually no conflict in representing not only both spouses but also the business entity. As the investigation proceeds, conflicts can and do develop.

Variations on a Theme. What if the taxpayers' first contact with the IRS was a dozen armed IRS Criminal Investigation Division special agents arriving at their residence or business with a search warrant? Typically, separate groups of Special Agents simultaneously raid both, and a third smaller group visits the accountant who prepared the returns. Typically, the clients initially tell us they said nothing or perhaps just a few things to the IRS during the several-hour search. Later, the special agents' twenty pages of single-spaced interview notes are furnished in discovery, and they reveal a far different story, and in considerable detail. If you receive a call during a raid, then remind the client of a valuable lesson given by our parents when we were quite young: "Don't talk to strangers." Taxpayers should be forcefully told this is one of those moments in life when silence is truly golden.

If a client calls and informs you that his or her home or business is being searched, the best and probably most valuable advice they can receive is simple—other than stating one's name, say absolutely nothing. There is a reason that special agents read clients their rights. Clients should not talk to the IRS strangers, even to acknowledge or identify assets or documents, discuss who does or does not perform record-keeping functions, engage in any dialogue about bank-

ing or business practices, etc., as all are ill-advised.

Client meetings and phone calls as described above make the practice of tax law so interesting.

NOTES

1. 127 S Ct 2011, 2007 US LEXIS 6081. The court in *Hinck* held that the Tax Court has exclusive jurisdiction to review the IRS's refusal to abate interest under IRC 6404(e)(1).
2. *United States v Kovel*, 296 F2d 918 (2d Cir 1961).



Paul L.B. McKenney, of Varnum Riddering Schmidt & Howlett LLP, Novi, practices in the areas of tax and business planning. He is a member of the Taxation Committee of the Oakland County Bar Association; the Sales, Exchanges, and Basis Committee of the Taxation Section of the American Bar Association; and the Taxation Section of the State Bar of Michigan. Mr. McKenney has also served as co-chairperson of the Taxation Committee of the Detroit Bar Association, as chairperson of the Oakland County Bar Association's Taxation Committee, and as a member of the State Bar of Michigan Taxation Section Council.