
MEMORANDUM

RE: **UNREPORTED INCOME**: IRS CRIMINAL & CIVIL TAX ISSUES

DATE: OCTOBER 31, 2007

I. UNREPORTED INCOME (IRS Criminal Tax Issues)

1. IRC § 7201: Acts to Evade or Defeat Collection of Tax

“It is a crime to evade or defeat any tax” (it is a felony to willfully attempt in any manner to evade or defeat the collection of a federal tax).

2. IRC § 7206: False Statements/Aid or Assist

“It is a crime to make false statements to the IRS,” or to “aid or assist” in defeating the tax process.

3. IRC § 7212: Obstructing or Impeding

“It is a felony to obstruct or impeded the due administration of the federal Internal Revenue Code, including the collection of tax owed” (U.S. v. Reeves 752 F.2d 995, 998, 5th Cir. Cert denied 474 U.S.834 (1985)).

4. “A person may be charged with conspiracy to impede collection of a federal tax as well as with a separate charge of impeding.” (18 U.S.C. 371)

II. ATTORNEY’S ETHICAL DUTIES (ABA)

ABA Model Rules of Professional Conduct Rules 1.2 and 1.6:

Model Rules of Professional Conduct Rule 1.2 – Scope of Representation

- (d) A lawyer shall not counsel a client to engage, or assist a client in conduct the lawyer knows is criminal or fraudulent**

Model Rules of Professional Conduct Rule 1.6 – Declining or Terminating Representation

(a) Except as stated in paragraph (c) [court orders lawyer to continue representation], a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) The representation will result in violation of the rules of professional conduct or other law. . .

III. CRIMINAL TAX FRAUD

1. Penalties

IRC §7201 imposes criminal penalties on “any person who willfully attempts in any matter to evade or defeat any tax” A violation of Section 7201 is a felony and conviction under this provision invokes a maximum fine of \$100,000 for individuals and \$500,000 for a corporation, or a maximum imprisonment of five years, or both, and the payment of prosecution costs.

A “willful attempt” requires more than just the failure to file a tax return or report taxable income. Such an attempt requires a positive, voluntary act designed to mislead the Service or conceal income. [U.S. v. Meek, 998 F.2d 776 (10th Cir. 1993)] Essentially, there must be an intent to avoid tax and the performance of some affirmative act to further the intent. [U.S. v. Jannuzzio, 184 F. Supp. 460 9D. Del. 1960)]

2. Burden of Proof: (Civil Fraud cf. Criminal Fraud)

Criminal fraud requires a higher standard of proof than civil fraud. The government must prove “beyond a

reasonable doubt” that the defendant is guilty of criminal fraud, whereas in civil fraud, the burden required is a mere preponderance of the evidence (also termed as “by clear and convincing evidence”). Therefore, a criminal decision of a court or jury will bind a civil decision, but a civil decision does not bind a criminal one.

3. Statute of Limitations: (Civil and Criminal Proceedings)

For civil tax fraud (i.e. unreported income), there is no statute of limitations (the tax can be assessed at any time)

For criminal tax evasion (i.e. unreported income), the criminal statute of limitations is only on the prosecution of the crime i.e. tax evasion (not the assessment of tax owed).

The Federal Criminal Code contains a general limitations period for prosecutions under Title 18, U.S.C.A., of five years after the commission of the crime. When the prosecution is for the offense of willfully attempting in any manner to evade or defeat any tax, the limitation is six years.

Other offenses arising under the Internal Revenue laws generally have a three-year period of limitation for prosecution. [IRC §6531(1)] Thus, the government can collect the civil penalties and tax and additionally get discovery information via civil proceedings that would be illegal under criminal proceedings (Fifth Amendment). After the three-year period, they can then begin criminal proceedings and use the civil file to prosecute.

IV. Attorney-Client Privilege

Attorney-client privilege does not protect participation in future crimes or frauds.

The Attorney-Client privilege does not include advice that assists the Client in the commission of a crime.

The subject matter of the privilege does not include advice that assists the client in the commission of a crime. A crime/fraud exception to the attorney-client privilege is recognized. A two-pronged test is applied to decide whether this exception exists: (1) Is there prima facie evidence showing that the client was engaged in criminal or fraudulent conduct when he sought the advice, that he was planning such conduct when he sought the advice, or that he committed a crime or fraud after receiving the benefit of counsel's advice and (2) is there evidence that the attorney's assistance was obtained in furtherance of the criminal or fraudulent conduct or that it was closely related to it?

Under this exception, no privilege applies where the desired advice refers not only to prior wrongdoing, but to future wrongdoing – i.e., to further either the crime charged in an indictment or future illegality.

Attorney-Client privilege legal issues:

Confidential communication between an attorney and a client for the purpose of obtaining or giving legal advice is generally protected from disclosure. Courts carefully examine whether the attorney produced the document in their role as legal counsel as opposed to some other advisory role.

The privilege extends to subordinates working for the attorney providing legal advice, such as an accountant hired by an attorney to interpret financial data. The privilege does not extend to non-legal experts hired independently by the client, but does include in-house counsel when giving legal advice. The privilege does not generally extend to the mere identity of legal clients and their fee arrangements.

The attorney-client privilege is recognized in tax-fraud cases, but it is not absolute. Although direct communication between an attorney and client is shielded, peripheral matters are not. The attorney may be required to disclose such things as the name of

his or her client, the client's financial status and tax payments, when and where matters were discussed, fee arrangements, involvement in litigation, and types of services, such as tax advice, rendered. (See *In re Grand Jury Subpoena Duces Tecum* [11th Cir. 1985]; *Frank E. Haddad*, 527 F.2d 537 [1976].)

In addition, the attorney-client privilege applies only if the attorney is acting in the capacity of an attorney.

The attorney-client privilege belongs to the client rather than the attorney. This distinction is important when the taxpayer's business is subsequently controlled by a legal successor, such as a trustee in bankruptcy.

The party claiming attorney-client privilege must specifically assert the privilege at an early opportunity. Failure to assert the privilege may be considered waiver, as is disclosure to a non-privileged third party. Waiver is interpreted broadly. If a taxpayer waives privilege as to one document, it may be waived as to all other documents relating to that particular matter. Material provided to assist in the preparation of tax returns is deemed to be intended for disclosure, and thus the privilege is waived. Privilege may also be waived by court filings, SEC filings, or by allowing the IRS to review files.

Indirect testimonial use of an opinion to avoid penalties has also been held to waive privilege. Courts occasionally order *in camera* review of allegedly privileged documents, but this review alone should not operate to waive privilege. Production of documents to a state or foreign government, however, may waive the privilege.

In opposing an attorney-client privilege claim on grounds of the crime/fraud exception, the IRS may request that the district court conduct an in-camera review of allegedly confidential communications to determine whether these communications fall within the crime/fraud exception. However, before the request can be granted, the Supreme Court in *United States v. Zolin* (109 S.Ct.

2619 (1989)) stated that the party seeking in-camera review “must present evidence sufficient to support a reasonable belief that in camera review may yield evidence that establishes the exception’s applicability.”

The purpose of the privilege “is to encourage clients to make full disclosure to their attorneys.” Thus, it protects communications by the client to the lawyer in both oral and written form – that is, the client may make the communication orally or in writing to the lawyer. However, preexisting records do not become confidential communications by their mere delivery to an attorney. The status of the records in the lawyer’s hands depends on their status in the taxpayer-client’s hands.

In *Fisher v. United States*, (425 U.S. 391 (1976)), the Supreme Court distinguished between a document that already had independent existence, the information in which is communicated to a lawyer, and physical possession of a preexisting document. The preexisting document is not covered by the privilege unless it is otherwise confidential in the hands of the taxpayer-client. For this reason, a taxpayer’s attorney may be compelled to produce an accountant’s workpapers because such workpapers would not have been privileged from production in the hands of the taxpayer-client.

The IRS is requesting tax accrual and other financial audit work papers from taxpayers under certain limited circumstances. In Announcement 2002-63, 2002-2 C.B. 72, the IRS has put practitioners on notice that it will request and summon, if necessary, tax accrual workpapers when it examines tax returns that claim any of the “listed transactions” that have been identified by the IRS as tax-avoidance or abusive-tax transactions.

These work papers are compiled by clients’ accountants to determine the extent of reserves necessary to cover potential tax liability. They often disclose questionable transactions and positions taken by the client.

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The announcement affects tax returns filed on or after July 1, 2002. The IRS has determined that neither the attorney-client privilege nor Section 7525 (dealing with tax practitioner privilege) protects these work papers. However, the IRS will use restraint, as has been its policy in the past, with regard to requests for this information in areas other than listed transactions.

The IRS maintains agreements with most states and cities to share audit information. States also provide refund information to the IRS) When the IRS has audited a return that should require a state tax change, many states provide that their assessment statutes for such changes do not close until notification of the change is given by the taxpayer to the state tax authority.

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