PROCEDURES AND TECHNIQUES
IN THE DISCOVERY OF HIDDEN INCOME

By: Barry A. Schatz, Esq.
Kalcheim, Schatz & Berger
161 North Clark Street
Suite 2800
Chicago, Illinois 60601
(312) 782-3456
Email: bschatz@ksbfamilylaw.com
Firm Website: www.ksbfamilylaw.com

INTRODUCTION

Discovering the source and use of hidden income is probably one of the more difficult and tedious tasks the divorce practitioner and forensic expert are retained to do. It is also a task which may involve significant risk to a lawyer's own client if it is discovered that the client knew or should have known about the activities of his or her spouse that would be considered tax evasion by the IRS. With this in mind, pay special attention in the drafting of any pleadings that are filed alleging the use of cash with unreported income. These pleadings are a public record and if the parties have filed any joint income tax returns, these pleadings could be construed as admissions against interest and could affect your client's right to claim being an innocent spouse as a defense in the underpayment of income taxes. The next issue is to try to find the money trail of cash flow so that your client can attempt to maintain the standard of living he or she would have enjoyed had the marriage not been dissolved. This exercise can only be accomplished by a fact specific investigation into the source and use of income and cash flow.

I. FINDING WHAT THE IRS CALLS "ECONOMIC REALITY"

In any divorce case where during the course of the parties' marriage there has been a substantial standard of living that was funded with unreported income, the issue is how to prove "economic reality," that is how much money the parties really used to support their standard of living. Not surprisingly, the IRS is often trying to establish "economic reality" as well, albeit for different reasons. According to the IRS Economic Reality Training Manual, economic reality is built from answers to these questions:

1. **What is the taxpayer's standard of living?**

   - What does the taxpayer and dependent family consume?
   - How much does it cost to maintain this consumption pattern?
   - Is reported net income sufficient to support this standard of living?

2. **What is the taxpayer's accumulated wealth?**

   - How much has the taxpayer expended in the acquisition of capital assets?
   - When and how was this wealth accumulated?
   - Has reported income been sufficient to fund the accumulations?
   - Funding of retirement plans.
   - Acquisition of real estate.
   - Servicing of debt.

3. **What is the taxpayer's economic history?**

   - What is the long term pattern of profits and return on investment in the reported activity?
   - Is the taxpayer's business expanding or contracting?
   - Does the reported business history match with the changes in the taxpayer's standard of living and wealth accumulation?

4. **What is the business environment?**

   - What is "typical" profitability and return on investment for the taxpayer's market segment and locality?
   - What are "typical" patterns of non-compliance in the taxpayer's market segment?
   - What are the competitive pressures and economic health of the market segment within which the taxpayer operates?

5. **Has the taxpayer made assertions to receipts of funds that the IRS considers to be non-taxable?**

   - Do claims of non-taxable sources of support make economic sense?
   - How credit worthy is the taxpayer in view of the taxpayer's assertion that funding was secured from loans?

- In situations where the taxpayer has asserted that funds were received from other than conventional lending institutions, what was the lender's source of funds?

In a divorce case, lawyers pursue the same information as the IRS, although with different goals in mind. Some of the information necessary to construct the economic reality may already be known by your client, such as things pertaining to maintenance of the residence or family members. Your client may be helpful in examining the following:

- How was housing acquired?
- If purchased, what was the source of the purchase price?
- How are real estate taxes paid?
- How were improvements paid for? (Review contracts)
- How was the marital residence maintained?
- How were utilities paid?
- Was there a second home purchased? If so, trace the source of funds.
- Verify any principal loan reductions.
- Were any time sharing investments made? If so, the source of acquisition.
- Payment of vacations?
- Payments to third parties including, but not limited to relatives, significant others and friends.
- Purchase of vehicles.
- Leasing of vehicles.
- Acquisition of boats, ATV's, other vehicles?
- Charitable contributions.
- Tuition for children at private schools.
- Payment to child care personnel (were income taxes withheld?)
- Payment for household help (were income taxes withheld?)
- Payment of rent.
- Acquisition of furniture and furnishings.
- Payment for interior decorator
- Purchase of horses
- Boarding of horses
- Payment of lessons
- Funding of Family Limited Partnerships, Charitable Trusts
- Payment for weddings
- Payment for relatives and significant others
- Purchase of stocks
- Funding of retirement plans
- Purchase of other assets
- Acquisition of collectibles
- Acquisition of art work
- Payment for online purchases

- Assets acquired by online auctions

But lawyers should also be alert to income hidden by or within a spouse's company or employer which may require the assistance of a forensic accountant to uncover. Unrecorded cash affects the valuation process and exclusion of gross revenues impacts the bottom line. Any time unrecorded cash is not considered in a business valuation, the valuations will be understated. Pay close attention to how the following items have been paid:

- Membership in Country Clubs
- Country Club Dues
- Initiation fees to any clubs
- Payment of health clubs
- Payment of cell phones
- Payment of insurance including, but not limited to home owners, life, disability, automobile, nursing home care
- Payment of professional fees
- Payment for personal or work
- Payment for furniture located in residence
- Gas
- Credit cards.
- Acquisition of collectibles.
- Business expenses
- Travel and entertainment
- Bartered goods and services
- Payroll – non-executives
- Leases for business equipment used personally
- Non-operating assets
- Non-recurring expenses
- Executive compensation (how structured)
- Trend analysis on expenses
- Capital expenditures (assets being expensed)
- Deferred compensation – phantom stock, stock appreciation rights
- House accounts with providers of goods or services
- Shareholder loans
- Business transactions with relatives or friends
- Parking profits with friends
- Bartering
- Prepayment of income taxes
- Payment for online purchases
- Payment of salaries for children or other relatives
- Payment to significant others

Discovery tools:

- See attached Appendix for discovery requests
- Request to Admit regarding acquisition of assets
- Request to Admit relating to proving payment for the specific asset such as jewelry, furs, collectibles, etc.
- Using Request to Admit for Characterization of Asset as a Gift (non-marital)
- Personal property floaters for jewelry, art work, etc.,
- Subpoenas
- Interrogatories.

II. INNOCENT SPOUSE EXCEPTION

In proving a cash case it is imperative that lawyers consider the exposure clients may have if they are successful in proving what they contend, i.e. that their spouse is guilty of income tax evasion or income tax fraud. In most situations parties file joint returns and each spouse is subject to Federal and State income tax liability, which is joint and several. Exception to liability is made only for the "innocent spouse."

I.R.C. § 6013(e)

A. <u>The Statute</u>
Under § 6013(e), a spouse can avoid liability for the other spouse's substantial understatement of tax if the following 5 requirements are met:

1. a valid joint return is filed; and

2. a substantial (i.e., in excess of $500) understatement of adjusted gross income attributable to erroneous items of one spouse occurs; and

3. the other spouse "***did not know, and had no reason to know***" that there was such a substantial understatement at the time the return was signed; and

4. taking into account all facts and circumstances, it would be inequitable to hold the other (innocent) spouse liable for the deficiency attributable to the substantial understatement.

A taxpayer spouse bears the burden of proving by a preponderance of evidence each prerequisite to qualify for innocent spouse status. See *Stevens v. Commissioner*, 872 F.2d 1499, 1505.

If all the above requirements are met, then the innocent spouse will be relieved of tax to the extent the liability is attributable to the substantial understatement.

B. "A Valid Joint Return"

* <u>Joint Filing Requirements</u>
  Under the Internal Revenue Code, a husband and wife are permitted to file a joint income tax return, even if one spouse has no income or deductions. The right to file a joint return is determined by the "marital status" of the parties on the last day of the calendar year. Thus, parties who are informally separated rather than divorced or separated by court decree on that day may elect to file a joint return for the year even if they are divorced after December 31.

* A Signed Return Presumes Authenticity and Knowledge of Contents

  A defendant's signature on a tax return gives rise to the presumption that the signature is authentic and that the defendant had knowledge of the tax return's content. <u>United States v. Kim</u>, 884 F. 2d 189 (5th Cir. 1989).

C. **"A substantial understatement of adjusted gross income attributable to erroneous items of one spouse occurs"**

* <u>Generally, Spouses are Jointly and Severally Liable</u>
  In allowing spouses to enjoy the benefits of filing a joint return, the federal government imposes on the parties the duty to exercise scrutiny in determining their respective and appropriate income and deductions. Accordingly, the law generally imposes joint and several liability on both spouses.

  If, however, a spouse can successfully establish that he or she was an "innocent spouse" as defined in the Internal Revenue Code, joint and several liability may be avoided.

* <u>Substantial Understatement</u>
  When one spouse fails to report income in excess of $500 or claims deductions that have no factual or legal basis.

D. **"The other spouse "*did not know, and had no reason to know*" that there was such a substantial understatement at the time the return was signed"**

* <u>"Reasonable Person Standard"</u>
In the landmark case *Sanders v. United States*, 509 F2d 162 (5th Cir. 1975) the court held that the appropriate standard to determine whether a taxpayer had "reason to know" of omissions or erroneous deductions is whether a "reasonable person" under the circumstances (or in the same position as the taxpayer at the time of signing the return) could be expected to know (or infer) that omissions or erroneous deductions had been made.

The *Sanders* court noted the "reason to know" test is the same test advanced by Restatement (Second) of Agency § 9, comment d (1958), which reads as follows:

> A person has reason to know of a fact if he had information from which a person of ordinary intelligence which such person may have, or if the superior intelligence which such person may have, would infer that the fact in question exists or that there is such a substantial chance of its existence that, in exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence. 509 F2d at 167.

* <u>Factors Determining Whether a Spouse Had "Reason to Know"</u>
Sanders utilized five factors to determine whether a spouse had reason to know of omissions from gross income:

1. unusual or lavish expenditures;

2. participation in business affairs or bookkeeping;

3. the "guilty" spouse's refusal to be forthright about the couple's income;

4. the claimant spouse's emotional condition during the period in question; and

5. the complexity of the financial transactions that produced the funds. *Sanders* at 167-68.

(Based on these factors, the Court held that Mrs. Sanders had no reason to know of the omissions. In particular, the court placed significance on Mrs. Sanders' emotional problems and heavy alcohol consumption. The court warned that it would be wary of situations which indicated a spouse intentionally turned a blind eye upon the financial activities of the other spouse. 509 F2d at 168-69.)

* Duty of Inquiry
In certain situations, the “did not know, no reason to know” test gives rise to a “duty of inquiry”. A duty of inquiry is imposed when a spouse has sufficient knowledge of the facts underlying the claimed deductions (or omissions from income) such that a reasonably prudent person in the taxpayer’s place would question seriously whether the deductions were erroneous.

The innocent spouse rule mandates a fact intensive analysis. The practitioner is urged to analyze all available facts and relevant case law before counseling a client to file a joint return(s) during the pendency of litigation, and lawyers should help clients analyze the likelihood of being found an “innocent spouse” in respect of prior joint tax returns.

CONCLUSION

As always, it is a lawyer’s task to guide and counsel clients in pursuit of their long-term best interest, even if that goal is at odds with present-day priorities. Awareness of the legal and financial risks to one’s own client in pursuing hidden income can help temper the desire for a lengthy and often expensive discovery process that may be motivated by a desire for revenge or fear of future financial uncertainty. Lawyers have the responsibility to remind their clients that they may get everything they want, but in the end they may not want what they get.

APPENDIX

PRELIMINARY LIST OF INFORMATION AND DOCUMENTS REQUIRED FOR OF DETERMINING FINANCIAL NET WORTH AND CASH FLOW

PERSONAL ASSETS AND INCOME

1. Copies of all personal net worth statements prepared for any reason for the thirty-six months preceding the filing of a Petition for Dissolution of Marriage.

2. Personal state and federal income tax returns for the five taxable years preceding the filing of a Petition for Dissolution of Marriage all accompanying schedules, wherever filed.

3. Copies of all correspondence received from and/or sent to any income tax authorities during the immediately preceding thirty-six months.

4. Copies of financial statements of all closely-held business entities (including, without limitation, joint ventures, limited liability corporations, family limited partnerships, or any other form of ownership) in which ______ has a financial interest, for the five preceding years, including related income tax returns.

5. Copies of stock certificates for: investments in shares in the capital stock of publicly-traded companies not held in any brokerage account and closely-held corporations; stock rights; stock options, share warrants; bonds; debentures; annuities certificates of; treasury bills and bonds; interests in limited partnerships; interests in commercial partnerships; interests in joint ventures; pension plans; IRAs; ESOPs; employee profit sharing plans; stock option plans; stock option grants; put options; call options; ownership, whether actual interest in any entity including, but not limited to interest in hedge funds or trusts holding interest whether actual or beneficial; and any other investments of any nature whatsoever, held directly, indirectly or in any manner whatsoever, wherever located throughout the world.

6. Schedule of loans, accounts and claims receivable including date note taken, payment history and source of repayment from the date loan incurred to the present.

7. Schedule of all credit cards in the name of _________; including but not limited to Visa, MasterCard, American Express, Diner's Club, department store credit cards, oil company credit cards, including account numbers for each.

8. Copies of all credit card statements and supporting vouchers with respect to the credit cards referred to in 7 above for the thirty-six months preceding the date of filing of a Petition for Dissolution of Marriage.

9 (a) List of all bank accounts in ________'s name and, if applicable, his nominee(s), wherever located, indicating:

i. Name of banks
ii. Location
iii. Account number(s)
iv. Type of account

(b) List of all bank accounts closed during the immediately preceding five years, including location(s) of where accounts were located.

10. Copies of all bank statements and/or bank books for accounts referred to in 9 above, including cancelled checks, debt and credit memoranda/advices, as well as deposit slips for the said accounts.

11 (a) List of all safety deposit boxes in the name of _________ and nominee(s) if applicable, including location of each box.

(b) List of any person(s) having access to said boxes.

(c) List of any person(s) having access to said boxes.

12. Name and addresses of stockbrokers and investment advisors through whom ______ has placed buy or sell orders in respect of marketable securities and other investments as were reported on Schedule D on any income tax return filed or on any 1099B Form received within the last five taxable years.

13. Copies of all year-end 1099B, 1099D, 1099D and year-end statements received from the stockbrokers or investment advisors referred to in 12 above.

14 (a) Copy of insurance policy covering personal effects and other assets owned directly or indirectly by _______.

(b) Copy of life insurance policies on your life.

(c) Copy of any disability policy.

15. Copies of any wills and trust under which _________ is either a beneficiary.

16. Copies of all contracts, leases, employment agreements, shareholders' agreement, buy/sell agreements, partnership agreements, joint venture agreements, option agreements in effect, including all amendments thereto, to which ________ is a party (directly, indirectly, or in any manner whatsoever).

17. Copy of all applications for credit made with banks and any other lending or mortgage institutions wherever located, during the preceding thirty-six months, including copies of all accompanying documentation submitted to any lending institution, whether loan was obtained or not.

18. Schedule of all vehicles owned or leased by or for the personal use of _________ including, but not limited to, automobiles, boats, snowmobiles, sea-doos, aircraft, and motorcycles.

19. (a) Schedule of all real estate and interests therein owned by ________ directly, indirectly, or in any manner whatsoever, wherever located.

    (b) Copy of any real estate contract listings, contracts to purchase or sell real estate on behalf of ___________ or on behalf of any group of co-owners or joint ventures of which ________ is a member or owner, within the immediately preceding thirty-six months, whether real estate is currently owned or has been sold.

    (c) Copies of co-ownership and joint venture agreements, if any, in respect of the said real estate interests directly or indirectly held.

    (d) Copies of any offers received in respect of _________'s real estate holdings.

20. Details of any improvements and/or renovations made to __________'s residence during the past thirty-six months, including:

    (a) Description.

    (b) Cost.

    (c) Copy of specifications by architect or interior designer.

    (d) Method of payment.

    (e) Date(s) of payment.

    (f) Contracts entered into for improvements made to __________'s residence.

21. (a) Schedule of all gifts or transfers made by ________ to individuals, corporations, trusts or any other persons or entities, in excess of $1,000 during the immediately preceding thirty-six months, including nature of gift, value, name(s) of donee(s) or transferee(s), relationship, date of transfer of ownership.

    (b) Copies of relevant documentation with respect to (a) above.

22. Detailed breakdown of all sources of remuneration, including but not limited to salaries, bonuses, expense allowances, expense reimbursements, car allowances, country clubs, yacht clubs and other club dues and expenses, entertainment, season tickets for sporting events, and employment benefits received, directly, indirectly or in any manner whatsoever, including constructively.

23. Copies of all pages of current passport and, if said passport was issued within immediately preceding eighteen months, copies of all pages of prior passport.

24. Names and addresses of all travel agents used during the past three years to book ______'s travel.

25. Calendar for all out-of-town travel (outside radius of 100 miles from home/office) by ______, including:

    (a) Approximate cost per trip.

26. Copies of frequent flyer statements and other air-miles program statements for the preceding thirty-six months.

27. (a) Schedule of all credit cards used by _______ with respect to which ______'s company pays all or a portion of the charges thereon, for the preceding thirty-six months, including account numbers.

    (b) Copies of all expense reports submitted to employer and copies of all expense reimbursement records received from employer for the preceding thirty-six months.

29. Details of any contingent assets and liabilities of _______, including claims by or against __________, and the respective status of each.

30. Minute books of company(ies) controlled directly or indirectly by ________, or by an entity of which ______ is a member, including (without restriction) articles of incorporation, amendments thereto, by-laws, minutes and resolutions of shareholders and directors, and internal corporate policy statements, if any.

31. Schedule of jewelry, antiques, paintings, coin, stamp and wine collections, wherever situated in the world, including copies of purchase invoices and any appraisals relating thereto made within the immediately preceding thirty-six months.

33. Lit of all persons, if any, to whom _________ gave power of attorney (whether general or specific) during the preceding five years.

34. List of any *inter vivos* trusts or partnership created in the preceding five years, including name(s) of all capital and income beneficiaries.