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Think Like a Thief

Using tax returns to find hidden assets

By William B. Stewart, Jr. & Alison D. Gilmartin

There isn't any there there.

—Gertrude Stein, on returning to her hometown

You see things; and you say, “Why?” But I dream things that never were; and I say, “Why not?”

—from George Bernard Shaw's Back to Methuselah

How we look at things affects what we see, our paradigm or gestalt, if you will. Sometimes forensic accountants and attorneys are so absorbed in trying to figure out what is wrong with the information on a page that they completely overlook the information that should be on the page but is not. And, most often, those missing numbers and information are more important than all the flotsam and jetsam that are there. The errors of commission are often easy to spot; it is the errors of omission that constantly bedevil us.

A competent thief is not going to make a mathematical mistake on a document like a tax return; a competent thief just will not show a number at all. And so, to catch a thief, we must think like a thief.

Mining the metadata

In criminal law, one sees the worst people in the world trying to act their best. In family law, one sees the best people in the world trying to act their worst.

—Unattributed

A spouse may secrete assets from the marital estate, but he or she usually cannot hide the reporting trail. And, as all roads once led to Rome, all financial reporting roads lead to tax returns.

Metadata is “data about data.” In today's computer world, it often describes the digital data embedded in electronic files. But in family law, for financial purposes, it often refers to the invaluable data to be mined from the couple's personal tax returns.

The tax return—getting the real deal

Unless your client's spouse is wearing a halo, never assume that the proffered tax return is the real deal. Current software makes it easy to prepare bogus—but professional looking—personal and business tax returns. Often these returns and the real ones submitted (if at all) to the IRS bear no similarities. But, you ask, what about returns prepared by the trusted family attorney or CPA? Those are honest. Those are correct. The preparer has no incentive to falsify them. And he or she delivered them to the client directly. Your client has kept the signed copy of the original return.

All of the above are true. But have you made another fatal assumption? How do you know the returns were ever filed? Or that the signed returns were actually filed? In a recent case, the long-time family CPA prepared timely, annual tax returns for a wife and her spouse. The wife dutifully signed the returns and gave them to her high-earning husband, who promptly destroyed them and the annual six and seven figure checks to the IRS, diverting payments to another account. So, unless you know with metaphysical certitude that the returns you have are correct and complete, follow these steps and submit one of these forms to the IRS. Request at least five years of returns.

Lawyers/experts requests

Form 2848—Power of attorney and declaration of representative. Commonly referred to as a POA, this allows the representative to act in the same capacity as the taxpayer. Subject to the authority granted, a representative can generally perform any acts the individual or entity can perform, including receipt of refund checks. As an information-gathering technique, this solution is usually overbroad.

Form 8821—Tax information authorization. In some states, it is more advantageous to file individually (as opposed to a joint return). As such, one spouse might not be entitled to see the other spouse's return. To obtain that information, the filing spouse must execute Form 8821. This allows any individual, corporation, firm, organization, or partnership you designate to inspect and/or receive confidential information for the type of tax and the years or periods listed on Form 8821.

There are a couple of pitfalls that need to be avoided. First, a spouse can limit the periods or type of information requested. It is best, therefore, for the client's counsel/expert to prepare the form and have the other side execute it. Second, Form 8821 must be received by the IRS within 60 days of the date it was signed and dated by the taxpayer.

Client Requests

Form 4506—Request for copy of tax return. This allows your client to obtain an actual copy of his or her tax return. Your client must complete the form, specify the years requested, and submit a check for \$39 for each tax year, made payable to "United States Treasury." Allow 60 calendar days to receive the copies.

Form 4506-T—Request for transcript of tax return. From the IRS: Most needs for tax return information can be met with a computer print of the return information. This is known as a transcript. A return transcript will show all original information from the return as filed. If you need to have all changes and charges and credits, the client can

request a tax account transcript. Transcripts are provided free of charge. Transcripts will be mailed directly to the individual, and should be received within two weeks after the IRS gets the request. Transcripts can be mailed to a third party if specified on Form 4506-T, however, the person requesting the transcript must sign and date the form giving consent for the disclosure.

Notice that a request for a return takes up to two months, but a transcript only two weeks. When discovery deadlines and/or funds are tight, a transcript may be preferable. In all other cases, the original return is the document of choice.

Form 1040—Almost every line a potential goldmine. It is important to understand that tax returns are not examined in a vacuum. To be meaningful, the information on a specific line of a return must be compared to that same line on other returns and verified by sources of other financial information.

Social Security number for profiles and credit reports. The very first line of the Form 1040, U.S. Individual Income Tax Return, is often the most important—and the most neglected. That line gives the Social Security number of the filer(s). It will allow access to a veritable treasure trove of information. For less than \$100 per search, several national firms will provide a complete report on such topics as ownership of vehicles or real estate, business entities owned or officered, UCC filings, etc.

In addition, credit reports, obtained with the same Social Security number, will list all banks, mortgage lenders, and credit card companies with which the individual has done business. Credit reports will also give current amounts owing and high credit limits on each lender. Do not conduct a large property case without obtaining both of these documents. The costs are minimal, and the information critical. Each jurisdiction may have different legal requirements as to how this information is obtained.

Questions to ask

Following is a handy checklist of questions to ask when examining a personal tax return (Remember, errors of omission are more important than errors of commission.):

Wages, salaries, tips, etc. Attach Form(s) W-2.

- How do they compare to former years?
- How does this amount compare to the amount on the W-2?
- Is there, in fact, a W-2 attached?
- Is there a bonus to be paid in subsequent year?
- Have any options been vested but not exercised?

Schedules A through F and H and Form 4797 (See below.)

Lines 15 and 16—Retirement distributions

- Have any retirement accounts made distributions, early or otherwise?
- If so, where did they go?

- Was there an early distribution penalty?
- If it is/were a loan, has it been properly accounted for?
- Are there any early withdrawal tax consequences?
- Has the remaining balance in the retirement account been properly accounted for?

Line 20—Social Security benefits

- Are there any?
- If so, where were they deposited?
- Is the spouse eligible for benefits?

Line 28—Self-employed SEP, SIMPLE, and qualified plans

- Were there deductions in prior years?
- Have accounts for which the deductions were made been accounted for?
- Have you traced the deductions into those accounts?
- Do you have current statements on each account?
- Do you have all statements—since inception—on each account?

Line 30—Penalty on early withdrawal of savings

- Was this adjustment taken?
- If so, where did the money go?
- Have you identified the account or investment from where it was taken?

Line 32—IRA deduction (See line 28.)

Line 51—Foreign tax credit

- Does the spouse have foreign investments?
- Have they been identified?
- Were there amounts on this line previously but not now?

Line 53—Retirement savings contribution credit (See line 28.)

Line 58—Self-employment tax

- If there is a number here, has a Schedule C (Profit or Loss from Sole Proprietorship) been completed?
- Have all sources of self-employment income been identified and traced?
- Have all 1099s been supplied to you?
- Is there a separate bank account?

Line 64—Federal income tax withheld from Forms W-2 and 1099

- Does the attached W-2 agree with this line?
- Do these amounts change markedly from year to year without a commensurate change in income?

Line 65—Estimated tax payments and amounts applied from prior year's return

Does this amount agree with the amount of overpayment on prior year(s) returns? (In one case, a \$300,000 overpayment from a prior year was only about half that the next year. The client somehow “forgot” the rest.) The IRS will not automatically apply the proper amount.

Line 69—Amount paid with filed extension

- What was the source of this payment?
- Does the amount on the tax return agree with the amount on the extension form and the bank account?

Line 74—Amount of overpayment to be refunded

- Were these funds, in fact, refunded?
- Where were the funds deposited?
- Has the spouse made a habit of overpaying, in anticipation of a big refund when the divorce is final?

Line 75—Amount of overpayment to be applied to next year’s estimated tax
(See Line 65.)

If the overpayment is still due, has it been included as an asset in the current marital estate?

Line 76—Amount owed

- Has this amount been traced into a bank account?
- Has it actually been paid?

Schedules

The tax return (Form 1040) is supported by schedules that show the detail of various line items on the tax return. The most critical information is on these.

Line 40 itemized deductions (supported by Schedule A—Itemized Deductions)

- Have all paid real estate taxes been traced to real property assets?
- Have all paid personal property taxes been traced to specific personal property?
- Has all paid interest been traced to specific real property?
- Are safe deposit and/or investment expenses on Line 23 of Schedule A? (Very important.) If so, make sure to identify each asset.

Lines 8 & 9—Dividends and interest (supported by Schedule B—Interest and Ordinary Dividends)

- If interest income is listed, are corresponding interest-bearing accounts listed in the marital estate?
- Has the amount of interest income significantly decreased from prior years’ tax returns?
- Is each interest-bearing security from prior years on the current year’s tax return? If not, why not?
- Same questions for the dividends portion of Schedule B.

- Has the bottom of Schedule B been checked—
- “At any time did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?”
- Has this foreign investment section been checked in prior years but not this year?

Line 12—Business income or (loss) (supported by Schedule C—Profit or Loss from Business)

- Has gross income decreased significantly from prior years?
- Are expenses abnormal?
- Are there significant differences in particular line items from year to year?
- Is there any interest paid on mortgages—Line 16a?
- Have all net proceeds been traced into bank accounts?

Line 13—Capital gain or (loss) (supported by Schedule D—Capital Gains and Losses)

- Have the accounts from which these trades were conducted all been identified?
- Have the proceeds from all the sales been traced either back to the brokerage account or to a bank account?
- Can the taxpayer(s) use in future years a capital loss carryover?

Line 17—Rental real estate, royalties, partnerships, S corporations, trusts, etc. (supported by Schedule E—Supplemental Income and Loss)

- Have all assets described on Schedule E been traced to the marital estate? If not, why not?
- Are assets listed on Schedule E in prior years not on current or recent returns? If so, why not?
- Have all earnings, if any, from assets on this schedule been traced to various financial accounts?

Line 18—Farming income (supported by Schedule F—Profit or Loss from Farming)

- Have all these proceeds been traced?
- Have all underlying assets been identified?

Schedule G—There is not one.

Line 62—Household employment taxes (supported by Schedule H—Household Employment Taxes)

- Has the spouse been paying for domestic help that is not a part of your house?
- Line 14—Other gains or (losses) (supported by Form 4797—Sales of Business Property)
- Have all sales proceeds from each individual sale been traced to a financial account?
- Are there any remaining related assets that have not been divulged?

Conclusion

Mining the metadata of tax returns is not a panacea for all property work in family law, but it is a significant piece of the endeavor. From the (proper) tax returns and their related schedules, the entire financial world of the spouses should open. The work of the expert or attorney can either begin with the tax return or end with it. It is either proof of a posit or the start of an investigation into those marital assets and liabilities. For divorce cases without the funds to conduct large, comprehensive investigations, a thorough examination of the parties' personal and/or business tax returns is an economical and extremely beneficial way to find all types of helpful information related to issues in the divorce case.

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