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Tax Policy

Does your state permit sales of medical marijuana? If so, will you be prosecuted for filing your tax return and reporting your state medical marijuana income? You could, if you report illegal sources of income and fail to invoke your Fifth Amendment right against self-incrimination. In this article, Ropes and Gray LLP's Gabrielle G. Hirz and Kathleen Saunders Gregor, and Stefan G. Herlitz of Harvard Law School discuss filing and reporting income, even illegal income, and how the Fifth Amendment applies to tax returns and audits.

Remaining Silent Before the Tax Man

BY GABRIELLE G. HIRZ, KATHLEEN SAUNDERS GREGOR, AND STEFAN G. HERLITZ

You own a business selling medical marijuana, an enterprise which, while legal in 29 states and the District of Columbia, is prohibited by the Controlled Substances Act as a business trafficking in a Schedule I controlled substance. Although, under 2013 guidance, the Obama administration discouraged federal prosecutions of marijuana dispensaries that operated legally according

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to state laws permitting its medical or recreational use, perhaps you are more concerned under the current administration. When it comes time to file your Federal income tax returns, and those of your business, what are you legally obligated to disclose? What if you are an illegal gambler, or a sex worker, or you have not filed reports of your foreign bank and financial accounts (FBARs)? This is an issue faced every year by taxpayers with illegal sources of income or who believe their tax information could be used against them in a subsequent prosecution.

The Rights of Individual Taxpayers

Since 1927, when the Supreme Court pronounced in *United States v. Sullivan*, that income derived from an illegal business (there, a liquor seller flouting Prohibition) was nonetheless taxable, a taxpayer has been unable to claim Fifth Amendment privilege and, in the

words of Justice Oliver Wendell Holmes, “draw a conjurer’s circle around the whole matter by his own declaration that to write any word upon the government blank would bring him into danger of the law.” This means a taxpayer cannot decline to file a return entirely, but can invoke the Fifth Amendment if fully completing the return would require her to disclose information protected by the Fifth Amendment.

One successful example of a Fifth Amendment claim on a return is *Youssefzadeh v. Comm’r*, a recent case in which the IRS assessed a frivolous return penalty under §6702(a) against a taxpayer who had properly disclosed the total amount of his interest income on a Schedule B, but had refused to answer Part III (related to FBAR requirements) and blacked out the source and amount of certain interest items, expressly citing Fifth Amendment privilege. Mr. Youssefzadeh argued that the Schedule B lines he had blacked out asked for information that may trigger the duty to file an FBAR, and willfully failing to file an FBAR when required is a crime, so he was entitled to decline to answer these potentially self-incriminatory questions. The Tax Court agreed, and granted Mr. Youssefzadeh’s Motion for Summary Judgment, holding that his return was “substantially correct,” and that his Fifth Amendment claim was reasonable and not the sort of frivolous tax protester argument for which the penalty is designed. This decision demonstrates the principle that a taxpayer can claim Fifth Amendment privilege to withhold the source of her illegal income, but not the amount.

Failure to Assert Privilege

Asserting the privilege when filing a return is the taxpayer’s only opportunity to claim the privilege as to information inquired on the return – failure to assert it on filing the tax return bars a defendant from attempting to exclude incriminating information on the return during a subsequent criminal prosecution. Section 6103(i) of the Internal Revenue Code authorizes disclosure of tax return information to prosecutors for non-tax related criminal investigations on ex parte order by a federal judge. In *United States v. Barnes*, for example, prosecutors used this procedure to procure the tax returns of five defendants accused of participating in a conspiracy in violation of federal narcotics laws; the defendants had reported over \$1 million collectively in “miscellaneous” income, which prosecutors pointed to as ill-gotten gain. In *Garner v. United States*, the government introduced the petitioner’s tax returns, on which he had reported his occupation as “professional gambler,” as evidence of his participation in an interstate illegal gambling conspiracy.

Individual taxpayers may also make use of Fifth Amendment privilege claims in the context of a civil audit in certain circumstances. First, a taxpayer may cite the Fifth Amendment to refuse to answer questions as to potentially self-incriminatory information. Just this summer, the District Court for the Northern District of California held in *United States v. Liu* that a taxpayer had properly evoked the Fifth Amendment in declining to testify about his ownership of foreign entities and financial accounts and his knowledge of financial account reporting obligations. Second, the Supreme Court held in *United States v. Doe* that while the contents of business records do not benefit from Fifth Amendment privilege, the act of producing them may,

as it “tacitly concedes the existence of the papers demanded and their possession or control by the taxpayer. It also would indicate the taxpayer’s belief that the papers are those described.” Thus, a taxpayer who receives a summons from the IRS may cite the Fifth Amendment to refuse to produce certain documents if their production is a tacit admission of criminal activity. Although various courts have held that the Fifth Amendment privilege does not protect the production of “required records” that must be maintained by law, such as in the FBAR context, the privilege is available in other circumstances where taxpayers may be engaged in illegal businesses or activities.

The Fifth Amendment also prevents the government from using a taxpayer’s omission of information on a tax return or refusal to produce documents as evidence of guilt, provided the taxpayer expressly cited the Fifth Amendment in doing so. This means in Mr. Youssefzadeh’s case, the government would not be able to introduce his omission of Schedule B items and refusal to answer questions on his tax return as evidence to demonstrate he had willfully failed to file an FBAR when required.

The Rights of Business Entity Taxpayers

Under the “collective entity” doctrine, the Fifth Amendment is a personal, individual protection entirely unavailable to corporations and partnerships. Fifth Amendment protections are reserved for individuals and sole proprietorships; a corporation or partnership cannot enjoy them even if closely held by a single, primary shareholder and their family. Because of this, a corporation cannot cite the Fifth Amendment to omit items on its tax returns, nor can it invoke the privilege to avoid disclosure of narrative testimony or documents when compelled by an IRS summons.

Since a corporation itself is unable to testify, it must do so through one or more agents, such as a custodian of records. A custodian of records cannot invoke Fifth Amendment privilege to avoid turning over corporate records in an audit, even if those records might criminally implicate them, as they hold those records solely in a representative capacity for the entity. If the custodian refuses to turn over corporate records in response to a summons, they could be compelled to do so by a federal court, and persistence in such a refusal can lead to a penalty. In *Barnes v. Comm’r*, for example, the petitioners refused to produce income records of trusts for which they were trustees, citing the Fifth Amendment; the Tax Court granted the government’s motion to compel production, and further assessed a frivolous argument penalty under section 6673 due to petitioners’ repeated insistence on their Fifth Amendment claim. In the absence of a grant of immunity, a custodian of records cannot be compelled to incriminate herself by her own oral testimony, but may be compelled to testify orally as to the authenticity of records produced. Because production of records by its custodian is deemed an act of the corporation, the government cannot introduce evidence that the defendant was the particular individual to produce the records in a later prosecution. Unfortunately, as the Supreme Court recognized in *Braswell v. United States*, that may be little consolation when “the jury may, just as it would had someone else produced the documents, reasonably infer that [s]he had possession of the documents or knowledge of their contents.”

Lack of Fifth Amendment Privilege

While an important caveat for businesses in general, this lack of access to Fifth Amendment privilege when dealing with the IRS is particularly concerning for illegal businesses and their employees, who can do little to prevent compelled, civil disclosure of criminally incriminating information in the event of an audit. State-legal marijuana businesses and their employees can be prosecuted as a result of information gathered through IRS enforcement of section 280E of the Code, which disallows ordinary and necessary business expense deductions to businesses operating in violation of the Controlled Substances Act. In the event of an audit, the custodian of records of a marijuana business can be civilly compelled to turn over all of the information required to prosecute them and the other employees for Federal drug trafficking crimes. In recent years, several marijuana businesses, particularly in Colorado, have been ordered to hand over records to the IRS in section 280E investigations. Unfortunately there is no surefire way to avoid such an investigation – aside from operating a different business – although taxpayers may try to do so hewing carefully to the limitation imposed by section 280E and only deducting cost of goods sold. This is also consistent with the professional responsibility obligations of tax practitioners working with state-legal marijuana businesses, as described by the IRS Office of Responsibility Director Stephen Whitlock on a July 19, 2017 webcast. Still, nothing prevents the IRS from auditing even correctly prepared returns to verify that they properly reflect a taxpayer's income.

Similar concerns exist for other varieties of illegal business which are subject to specific restrictions in the tax code, particularly if they are illegal at the state level

as well; losses from wagering transactions, for example, are allowed by section 165(d) of the Code only to the extent of wagering gains for the year. If an individual has illegal gambling winnings, they must report the amount on her return, but can exercise their Fifth Amendment privilege to exclude the source from the return and to refuse to produce the source in an audit. If they run an illegal gambling partnership, however, and the partnership is subject to an audit, the IRS can compel them, as custodian, to turn over records of the gambling income, and those records could then be used against them and their partners in a criminal prosecution.

In Conclusion

The Fifth Amendment is a shield from compelled self-incrimination, and individual taxpayers may enjoy some of its protections when filing a tax return or responding to an IRS summons in an audit. While one cannot invoke the Fifth Amendment to avoid tax compliance entirely, it does allow a taxpayer to omit answers to certain questions – such as occupation or income source – or withhold certain documents. While business organizations are denied these protections, and therefore are more vulnerable to disclosure of incriminating records, their employees may still claim Fifth Amendment privilege and refuse to testify as to information not held for the organization in a representative capacity. Finally, before making a Fifth Amendment claim, an individual should beware that the privilege will only protect them in a later criminal prosecution; it can provide no protection from civil liabilities, such as those arising from misstated income or failing to file an FBAR.