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## Clues Abound: The Tax Return as an Investigative Tool



Tax returns can be highly effective investigative tools in fraud and divorce cases, shareholder litigation, and other situations in which a defendant may have hidden assets. In fact, virtually every page of a tax return can provide clues to hidden assets.

And examining several years' worth of returns can uncover telling trends.

For example, interest or dividend income in 2009 may reveal little, but significantly higher numbers for 2008 may indicate that the taxpayer sold stocks or other investments. Following the proceeds may lead to undisclosed assets.

### Revealing trends in the 1040

A forensic accountant starts the search for undisclosed assets with the taxpayer's Social Security number and other personal information in the Form 1040. Reviewing several years' returns can reveal previous addresses and

names as well as other avenues of investigation. The expert also reviews:

**Income from wages.** Using this information, the expert can determine if wage income is derived from multiple sources that may lead to undisclosed business interests. W-2 forms may reveal the existence of unknown retirement plans or other benefits.

**Interest and dividends.** Here the issue is underlying assets. If the amount of taxable interest or ordinary dividends exceeds \$1,500, the taxpayer is required to provide additional details on Schedule B. But even if the amount of interest and dividends is small, the underlying assets may be significant.

Tax-exempt interest is shown (but not taxable) on Form 1040 and may be reported on some state income tax returns. So the expert will likely look at both.

**Taxable refunds of state and local taxes.** Large refunds on previous returns may indicate that the taxpayer overwithholds as a savings strategy and

will be entitled to a substantial refund for the current year.

**Retirement plan distributions.** The expert will trace these funds to determine whether they were rolled over into other tax-deferred plans or used for some other purpose.

**Alternative minimum tax (AMT).** AMT entries may indicate shelters, credits, or other tax preference items, which may be evidence of hidden assets, such as real estate or incentive stock options.

**Refund amount.** Here, the expert will review large refunds from previous years and trace the proceeds. A taxpayer may hide assets by intentionally overpaying taxes in one year (for example, by neglecting to claim a tax benefit to which it's entitled) and then amending the return and claiming a refund in a later year.

### Tax return schedules

Even tax return schedules offer a wealth of information on hidden assets. For example:

*(continued)*

**Schedule A – itemized deductions** covers a taxpayer’s real estate and personal property taxes. The expert will check reported amounts to be sure they correspond to the underlying property. If they don’t, further investigation may lead to undisclosed assets. Entries regarding state and local income taxes may reveal income (or income-generating assets) in other states.

Payments of certain types of interest also can be deducted on Schedule A. Tracing mortgage interest to specific properties can lead to undisclosed real estate. If a mortgage has been refinanced, the expert will determine whether the taxpayer received any cash and, if so, trace the proceeds. An entry for investment interest paid may signal the existence of a margin account, which may contain undisclosed cash or securities.

Miscellaneous itemized deductions also can provide useful information. A deduction for rental of a safe deposit box, for example, may be the only clue available that such a box exists.

**Schedule B – Interest and ordinary dividends** can reveal the existence of foreign asset protection trusts, information that may not be available elsewhere.

**Schedule C – Profit or loss from business** contains information on depreciation, mortgage interest, and other expenses that relate to valuable real estate, business equipment, or other assets.

It also may reveal the existence of profit-sharing or other retirement plans. Insurance expenses may lead to life insurance policies with significant cash values.

**Schedule D – Capital gains and losses** information helps the expert investigate underlying transactions and trace the proceeds.

**Schedule E – Supplemental income and loss** reports income from rental properties, partnerships, S corporations, estates, and trusts. The expert will scrutinize the income and expenses for signs that these entities are being used to conceal assets.

#### **A powerful tool**

Whether assets have been actively concealed or simply overlooked, a party’s tax returns and supporting schedules can provide valuable clues on where to look and how to draft targeted discovery requests.

## How Do You Know if a Tax Return is Legit?

A tax return’s value as an investigative tool depends on the accuracy of the information it contains. Today, off-the-shelf software is routinely used to create professional-looking returns. So how do you know if you’re looking at the real thing?

Consider asking the taxpayer to complete and sign IRS Form 4506 (“Request for Copy of Tax Return”) to obtain a copy of the filed return directly from the IRS. Alternatively, you can use IRS Form 4506-T to obtain a transcript that shows most of the return’s line items.

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