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Mining Tax Returns for 'Gold'

Income tax returns can prove to be valuable tools in some common types of litigation, particularly matrimonial and shareholder disputes, if the "miner" knows what to look for and where to look. A CPA who has prepared hundreds, if not thousands, of tax returns each year is well suited to perform the necessary digging.

What Can't Be Found

Experts say that tax returns rarely reflect the true earnings of a business under generally accepted accounting principles (GAAP), primarily because of significant differences between GAAP and tax methods of accounting.

Many businesses will use an accrual basis for financial reporting purposes, but will prepare tax returns on a cash basis because it makes it easier to reduce the taxable income. The cash basis method of income reporting, therefore, seldom gives an accurate earnings picture, which can both help and hinder the search for relevant information.

Under the cash basis method, for example, a CPA can readily discern a business' cash flow, which can be used as one indicator of the business' value, although possibly a misleading one.

What Can Be Found

Tax returns can often be used to discern hidden assets, particularly through Schedules B, D, and E.

Schedule B, used by individual taxpayers to list interest and dividend income, may show that a taxpayer has tucked cash away in a financial institution, if interest income generated by those funds exceeding \$400 is listed (as of 2003, interest and dividend income need only be detailed if the amounts exceed \$1500). If line 8a on Form 1040 shows interest less than \$400, or if line 8b shows tax-exempt interest income, information should be sought on the underlying assets.

Schedule B should also show any dividends greater than \$400 that have been paid on stocks or bonds, and brokerage statements for interest and dividends. Again, if Form 1040 lists dividends of less than \$400, so that additional information is not required on Schedule B, the underlying assets should be explored.

Schedule D should be scrutinized for capital gains and losses. If capital transactions have occurred, discovery should be used to follow up on the disposition of the proceeds. Schedule E should list all "flow-through" activities, or entities in which the taxpayer has an interest.

If the taxpayer is a shareholder in an S corporation, limited liability corporation, or partnership, his tax burden for that entity should appear on Schedule E.

Schedule E may also show income from rental real estate, royalties, estates, and trusts. This, too, can provide information regarding assets owned by the taxpayer. If the incomes and expenses detailed on this schedule seem unreasonable, they may indicate money hidden in other accounts or siphoned to other entities.

A CPA will also look carefully at various uncategorized items, on both individual and business returns. These may be lumped into "other miscellaneous deductions," "other income," "miscellaneous income," and "other expenses." Income and expenses might be hidden in these locations to make them less visible to the Internal Revenue Service.

Start the Hunt Early

Tax returns should be obtained and scrutinized early on in the litigation process so they can be used to tailor discovery requests. Timely review of returns will allow the attorney and the CPA to determine if a return is suspicious and can help in decisions about the proper areas of concentration.