Statutory and Ethical Obligations to Report Tax Evasion
By Frank Agostino, Esq. and Valerie Vlasenko

The Court in *Sheridan v. Sheridan*, 247 N.J. Super 552 (Ch. Div. 1990) famously wrote that “[i]t is every citizen’s duty to uphold the law….” This article reviews what this duty means for New Jersey Courts and the officers that appear before them. Specifically, the article examines the obligations imposed by *Sheridan*, reporting obligations of mediators, arbitrators, and attorneys, the procedures for reporting noncompliance, and the means of avoiding *Sheridan* referrals.

I. **Obligation to Report Noncompliance with Tax Laws and Avoid Future Tax Crimes**

A. The Obligations Created by *Sheridan*

*Sheridan* addressed two separate and distinct issues: 1) whether the Court must report noncompliance to taxation authorities; and 2) whether the Court can divide the proceeds of a crime. Regarding the duty to report the Court held that trial judges must report parties to the appropriate authorities if there is evidence of intentional non-reporting or under-reporting of income.\(^2\) The Court explained:

> [i]t is every citizen's duty to uphold the law and as part of that duty to report any knowledge she or he may have of a crime committed or to be committed. In order to preserve public confidence in the integrity of the judicial system, a judge must be the ultimate exemplar of that good citizenship.\(^3\)

Second, the Court considered whether illegally obtained property is subject to equitable distribution\(^4\) and declared that New Jersey “do[es] not reward wrongdoers!”\(^5\) In the context of equitable distribution, the Court explained:

> To allow plaintiff to seek equity's aid in dividing marital assets acquired with illicit funds would substantially demean that policy and sully the judicial process. Courts cannot permit that to be done. Accordingly, this court concludes that a fair and common sense interpretation of the statutory purpose in permitting the division of "legally and beneficially acquired" property **bars the equitable division of property obtained with illicit or illegal funds.**\(^6\)

The Court ultimately decided that it cannot equitably divide marital property if such property was obtained with illicit or illegal funds because doing so would “substantially demean [the state’s public] policy and sully the judicial process.”\(^7\) Courts outside New Jersey have adopted *Sheridan* and extended its reach to alimony and child support:
A court may not base a future award of support upon "a future income from a continuous and persistent career of vice and criminality, and adopt as a basis of its decree a division of the anticipated spoils of [iniquity]." King v. King, seventy-nine Neb. 852, 113 N.W. 538, 539 (1907); see Seitz v. Seitz, 471 So. 2d 612, 614 (Fla. 3d DCA 1985) (citing King with approval). "It is against public policy to base a court order of support upon the assumption that [the husband] will violate the law in order to acquire the necessary funds to pay it. To base an order on anticipated unlawful conduct, not only recognizes, but also encourages," the future violation of the law.  

B. Sheridan’s Obligations are Broader than those under Federal Law

Sheridan’s first holding obligates litigants’ attorneys and judges with knowledge of a crime to report the crime to the appropriate authorities. As an initial matter, the obligations created by the Sheridan ruling are broader than those existing under the federal misprision of felony statute, which states that whoever has “knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be fined under this title or imprisoned not more than three years, or both.”

Misprision of felony requires prosecutors to prove beyond a reasonable doubt that: 1) the principal committed and completed the alleged felony; 2) the defendant had full knowledge of the fact; 3) the defendant failed to notify the authorities; and 4) the defendant tried to conceal the tax evasion from the IRS. A mere failure to report the felony to the IRS is insufficient for a criminal charge and conviction. By contrast, Sheridan imposes an unconditional obligation to disclose misconduct because of the Court’s conclusion that “[a]s the ultimate repository, the gatekeeper of that conscience and morality, equity's forum can never be used to promote or condone crime or clearly defined breaches of public morality.”

Critics of Sheridan argue that it undermines the attorney-client privilege and complicates matrimonial litigation. For the reasons set forth below, Sheridan’s critics often fail to understand the limits of statutes protecting confidentiality, the court rules, and professional obligations as to the need to prevent future crimes. More importantly, judges and most witnesses, including experts and forensic accountants, have no obligation to protect client confidences. Thus, they may have an affirmative obligation to disclose violations of tax law violations under Sheridan and the misprision of felony statute.

C. Sheridan Stops Attorneys and the Courts from Aiding, Assisting, or Abetting Crimes

Sheridan’s second holding concerns division of property acquired with illicit or illegal funds. Specifically, the Court stated that “[e]ven in the absence of [ ] statutory direction, the result must be the same: equity will follow the common law precept that no one shall be allowed to benefit by his own wrong doing.” The Court’s refusal to divide the proceeds of a crime, prevents the
wrongdoer not only from benefiting from a past crime but also thwarts the Court from furthering the crime. Sheridan’s obligation is perhaps broader than the laws against aiding and assisting and aiding or abetting tax crimes.

18 U.S.C. § 2 states that “[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.” (Emphasis added). Aiding and abetting is not itself a substantive crime but simply makes someone not otherwise a principal of a substantive crime a deemed principal of the crime by virtue of aiding and abetting. Applying this statute to matrimonial actions invites litigation as to whether a Court order dividing and allowing for distribution of assets obtained with illicit funds aid and abet the illicit conduct of the taxpayer. By imposing an unconditional prohibition on distribution of such funds, the Sheridan court avoids the question.

Similarly, attorneys and other tax professionals cannot aid and assist the future crimes of their clients. Internal Revenue Code (“I.R.C.”) § 7206(2) provides that it is a felony to willfully aid or assist in, or procure, counsel, or advise “the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document.” By prohibiting the division of proceeds of tax evasion, the Court avoids putting attorneys in conflict with their obligations to the Court and their clients.

Sheridan, teaches that judges, mediators, arbitrators, attorneys, and witnesses should: 1) consider whether they have an obligation to disclose information about the taxpayer’s past crimes; and 2) be careful not to assist in the commission of any future crimes.

D. Sheridan Makes the Crime Fraud Exception and the Duty of Candor Applicable to Every Filing in a Matrimonial Case

Sheridan’s second holding (i.e., the Court cannot equitably divide marital property if such property was obtained with illicit or illegal funds) has the unintended consequence of subordinating the attorney’s duty of the confidentiality to the client to the attorney’s obligation of candor to the tribunal.

Under Rule 1.6 of the New Jersey Rules of Professional Conduct, an attorney cannot “reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation.” The duty is not absolute and courts have created several exceptions where an attorney may have to reveal the client’s confidential tax information. Among the exceptions is the crime-fraud exception. The Supreme Court has explained that:

The attorney-client privilege is not without its costs. Since the privilege has the effect of withholding relevant information from the factfinder, it applies only where necessary to achieve its purpose. The attorney-client privilege must necessarily protect the confidences of wrongdoers, but the reason for that protection—the
centrality of open client and attorney communication to the proper functioning of our adversary system of justice—ceases to operate at a certain point, namely, where the desired advice refers not to prior wrongdoing, but to future wrongdoing. It is the purpose of the crime-fraud exception to the attorney-client privilege to assure that the “seal of secrecy” between lawyer and client does not extend to communications made for the purpose of getting advice for the commission of a fraud or crime.¹⁵ (Emphasis added)

*Sheridan* suggests that the crime-fraud exception to the attorney-client privilege does not protect communications relevant to the division of assets acquired with tax evaded funds. Once the attorney-client privilege no longer applies the duty of confidentiality must yield to the attorney’s duty of candor to the court. Rule 3.3 provides that lawyers cannot knowingly:

1. make a false statement of material fact or law to a tribunal;
2. fail to disclose a material fact to a tribunal when disclosure is necessary to avoid assisting an illegal, criminal or fraudulent act by the client;
3. fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel;
4. offer evidence that the lawyer knows to be false. If a lawyer has offered material evidence and comes to know of its falsity, the lawyer shall take reasonable remedial measures; or
5. fail to disclose to the tribunal a material fact knowing that the omission is reasonably certain to mislead the tribunal, except that it shall not be a breach of this rule if the disclosure is protected by a recognized privilege or is otherwise prohibited by law.

Under the crime-fraud exception and the duty of candor an attorney’s obligation to disclose his or her client’s crimes begins at the beginning of a matrimonial action. Moreover, New Jersey Court Rules require that a “case information statement... shall be filed and served in all contested family actions, except summary actions, in which there is any issue as to custody, support, alimony, or equitable distribution.”¹⁶ The case information statement (“CIS”) must be filed within twenty days of filing an answer or an appearance or by court order.¹⁷ The parties must notify the court of any material change to the CIS.¹⁸ If an attorney knows of a material change in a client’s income, the attorney should amend the CIS as soon as possible and within twenty days before the final hearing.¹⁹
This suggests that an attorney must address the *Sheridan* issue at the beginning of the case. At a minimum the client should be advised against continuing the fraudulent activity. Further, the attorney should be careful to not aid or assist in the tax crime. If the client wants to disclose the *Sheridan* issue to the court, the attorney should amend the CIS and obtain a competent tax professional, who is experienced in the federal and state voluntary disclosures.

Attorneys cannot avoid their obligation of candor to the tribunal by avoiding the acquisition of knowledge of a tax crime. In New York, a judge found that an attorney’s certification that he had no knowledge that “the substance of any of the factual submissions contained in the... [a]ffidavit is false” to be disingenuous. The court forwarded the attorney’s affidavit and certification to the appropriate Departmental Grievance Committee for review.

### E. Reporting Obligations in Complementary Dispute Resolution Programs

Under the New Jersey Court Rules and the New Jersey Mediation Act, no party, mediator, or other participant in mediation may disclose mediation communications to non-participants, like the IRS or N.J. However, a mediator: 1) may disclose a mediation communication to prevent harm to others to the extent such mediation communication would be admissible in a court proceeding; and 2) must disclose to a proper authority information obtained at a mediation session if required by law... The mediator’s duty to disclose information “if required by law,” coupled with the obligations imposed by *Sheridan* and the federal misprision of felony statute, may be interpreted as requiring that mediators disclose information related to tax crimes to the appropriate authorities.

Arbitrators do not have confidentiality and disclosure obligations under the New Jersey Court Rules or any statutes. Arbitrators working with the American Arbitration Association, have a contractual confidentiality obligation. It is unclear whether an arbitrator’s contractual obligation trumps the duty to disclose imposed by *Sheridan* and the misprision of felony statute. But information regarding a crime may ultimately be subpoenaed under the crime-fraud exception.

Regardless of whether a duty to disclose exists, under the holding of *Sheridan* discussed above, neither mediators nor arbitrators may preside over the division of crime proceeds. Mediators and arbitrators should recommend that the parties amend their returns or undergo a voluntary disclosure and stay the proceeding until the tax issues are resolved. Dividing the proceeds of a crime may be aiding the tax law violations under 18 U.S.C. § 2 and I.R.C. § 7206(2).

### II. Reporting Noncompliance with Tax Laws

#### A. *Sheridan* Referrals and the Court

A *Sheridan* referral can be made at any stage of a legal proceeding. To notify taxing authorities of any wrongdoing, a judge may submit a copy of the decision or write a letter that documents his or her findings to the tax authorities. New Jersey Courts, the IRS, and New Jersey Division of Taxation each have their own procedures for dealing with *Sheridan* issues.
1. Constructive Trust and Staying Proceedings

In *Sheridan*, the Court imposed a constructive trust on the remaining marital assets and stayed the proceedings for up to one year after the judgment until the IRS and N.J. intervened and filed their claims. \(^{25}\) I.R.C. § 7424, although rarely invoked, authorizes intervention in marital actions:

If the United States is not a party to a civil action or suit, the United States may intervene in such action or suit to assert any lien arising under this title on the property which is the subject of such action or suit. The provisions of section 2410 of title 28 of the United States Code (except subsection (b)) and of section 1444 of title 28 of the United States Code shall apply in any case in which the United States intervenes as if the United States had originally been named a defendant in such action or suit. In any case in which the application of the United States to intervene is denied, the adjudication in such civil action or suit shall have no effect upon such lien.

A court may impose a constructive trust and stay the legal proceeding to protect the marital assets from distribution pending the taxing authority’s investigation of the referral and/or litigation of the government’s claim.

2. Appointment of Tax Receivers

An alternative to waiting for a *Sheridan* referral is filing a motion for the appointment of a receiver and the imposition of a constructive trust on the tainted assets. \(^{26}\) A custodial receiver, sometimes called a Tax Receiver, holds the property in *custodia legis*. \(^{27}\) That is, the property cannot be disposed of without court approval. \(^{28}\) After that appointment, the court can authorize the Tax Receiver to:

- review each parties’ tax returns;
- evaluate the pros and cons of the IRS and N.J.’s voluntary disclosure programs; and
- advise the court whether innocent spouse relief or other equitable relief from liability could apply. \(^{29}\)

A Tax Receiver may recommend and facilitate: 1) the filing of qualified returns; 2) the entry into a voluntary disclosure program; or 3) the filing suit under 28 U.S.C. § 2410 to determine the extent and validity of the government’s claim. \(^{30}\) The appointment of Tax Receivers, who are often expert tax professionals, can provide benefits for clients, courts, and attorneys. Tax Receivers may limit the taxpayer’s exposure to civil or criminal liability (criminal tax investigations or perjury charges), assist attorneys in fulfilling ethical obligations to the clients and the courts, protect the best interests of the children and increase the courts’ efficiency without a *Sheridan* referral. \(^{31}\)
B. Reporting Suspected Tax Law Violations to the IRS

The IRS encourages all U.S. citizens to report individuals who do not report their taxes accurately or evade taxes entirely. To facilitate reporting of noncompliance, the IRS has created Form 3949-A, Information Referral. Noncompliance includes claiming false exemptions or deductions, receiving or providing kickbacks, submitted or providing false or altered documents, failing to report or pay taxes, not reporting income or assets, submitting or providing false or altered value of assets, engaging in organized crime activities, or failing to withhold taxes.\(^{32}\)

To complete Form 3949-A the reporting party must:

- provide the taxpayer’s information name, street address, city, state, ZIP code, social security number or taxpayer identification number, occupation, date of birth, marital status, the spouse’s name (if married), and email address;
- check all tax violations that apply to the report;
- include the years and dollar amounts of unreported income;
- briefly describe the facts of the alleged tax law violations;
- any additional information necessary; and
- provide information about the reporting party.\(^{33}\)

The reporting party may submit a letter with the following information:

- name and address of the person or business reported;
- the individual’s social security number or the business’s employer identification number;
- a brief description of the alleged violation(s), including how the party you realized or got the information about the violation(s);
- the years involved;
- the estimated dollar amount of any unreported income; and
- the reporting party’s name, address, and telephone number.\(^{34}\)

Form 3949-A or a letter should be mailed to Internal Revenue Service, Stop 31313, Fresno, CA 93888. To encourage reporting, the IRS keeps reporting parties anonymous.\(^{35}\) Tax crimes may also be reported by phone. The point of contact for the IRS in New Jersey is Robert Glantz.

C. Reporting Suspected Tax Law Violations to New Jersey

In New Jersey, judges and other individuals can report tax fraud if the taxpayer:

- willfully failed to report all income received;
- falsely claimed to be a resident of another state;
- filed a fraudulent return;
- failed to file state income tax returns;
• opened and closed a new business to evade taxes;
• prepared records that understate income or overstate expenses of a business; and/or
• failed to turn over collected, withheld tax.\textsuperscript{36}

Tax fraud can be reported by phone or mail.\textsuperscript{37} Similarly to IRS disclosure requirements, the taxpayer’s name and address, date of birth, tax identification number, address, description of the tax violation, the affected tax type, an explanation of how the reporting party noticed the violation and how long it has continued, asset information, and the reporting party’s contact information must be disclosed.\textsuperscript{38} Reports may also be made anonymously.\textsuperscript{39}

\textbf{III. Avoiding Sheridan Referrals}

Matrimonial attorneys will sometimes file amended returns for taxpayers to avoid a Sheridan referral.\textsuperscript{40} Filing amended returns does not guarantee that a client will not be criminally prosecuted.\textsuperscript{41} To avoid Sheridan referrals taxpayers should take advantage of federal and state voluntary disclosure programs. Voluntary disclosure programs enable taxpayers to become compliant with their tax obligations, avoid substantial civil penalties, and avoid the risk of criminal prosecution. Voluntary disclosures also provide the opportunity to calculate, with a reasonable certainty, the total cost of resolving all tax issues.\textsuperscript{42}

\textbf{A. IRS Voluntary Disclosure Program}

While a voluntary disclosure reduces the chance of prosecution, it is not a guarantee; the IRS will determine whether criminal prosecution is warranted based upon each taxpayer’s facts and circumstances.\textsuperscript{43} The IRS also emphasizes that this program does not apply to taxpayers with “illegal source income.”

On November 20, 2018, the IRS released the process for all voluntary disclosures (domestic and offshore).\textsuperscript{44} Any voluntary disclosure to the IRS must be truthful, timely, and complete.\textsuperscript{45} The taxpayer must cooperate with the IRS and make good faith arrangements to pay the tax, interest, and any penalties (if applicable).\textsuperscript{46} A voluntary disclosure is timely if the disclosure is received before: 1) the IRS initiates a civil examination or criminal investigation or the taxpayer receives notice of the IRS’s intention to commence an examination or investigation; and/or 2) a third party (like a judge’s Sheridan referral) informs the IRS of the taxpayer’s noncompliance.\textsuperscript{47}

If failing to report foreign financial assets and pay all tax due did not result from willful conduct, or the taxpayer has reasonable cause for not disclosing foreign income or assets, he or she should take advantage of Streamlined Filing Compliance Procedures or the Delinquent International Information Return Submission Procedures.

\textbf{B. New Jersey Voluntary Disclosure Program}

New Jersey has its own voluntary disclosure program that allows taxpayers to become compliant with state tax laws. The program provides for a reduction or waiver of penalties and limits the
potential for criminal prosecution. To be eligible for the program, the taxpayer must meet the following requirements:

- be a New Jersey Resident or Non-Resident;
- have no prior contact with the Division of Taxation regarding delinquencies or deficiencies;
- not currently be under criminal investigation;
- be willing to file the requested returns and pay the outstanding tax liabilities within an established timeframe; and
- not be amending a previously filed individual return.

The taxpayer must request a voluntary disclosure agreement in writing, explaining the tax years involved and the reasons for not filing their tax return. If accepted, New Jersey will send a letter of confirmation. After signing and accepting the agreement, New Jersey will waive the late-filing and payment penalties for the relevant tax years but will assess a 5% post-amnesty penalty along with statutory interest.

C. Notice of Federal Changes

A taxpayer who undergoes a federal voluntary disclosure must simultaneously apply for a state voluntary disclosure program to comply with New Jersey’s Notice of Federal Change statute. N.J.S.A. § 54A:8-7 states:

[i]f the amount of a taxpayer's federal taxable income or earned income tax credit reported on the taxpayer's federal income tax return for any taxable year is changed or corrected by the United States Internal Revenue Service or other competent authority, or as the result of a renegotiation of a contract or subcontract with the United States, the taxpayer shall report such change or correction in federal taxable income or earned income tax credit within 90 days after the final determination of such change, correction, or renegotiation, or as otherwise required by the director, and shall concede the accuracy of such determination or state wherein it is erroneous. Any taxpayer filing an amended federal income tax return shall also file within 90 days thereafter an amended return under this act, and shall give such information as the director may require. The director may by regulation prescribe such exceptions to the requirements of this section as the director deems appropriate. (Emphasis added).

Once the taxpayer notifies the Division of Taxation of a change in federal taxable income or files an amended return, any additional New Jersey taxes must be assessed against the taxpayer “within 2 years after such report or amended return was filed.” If no notice is provided, New Jersey may assess the additional tax against the taxpayer at any time.
D. Voluntary Disclosure by a Single Party

A taxpayer has the option to file a voluntary disclosure without the consent of the other party on the jointly filed return. IRS voluntary disclosures generally require examinations of the most recent six tax years. Taxpayers prepare and submit all required returns and reports to the examiner for a determination of applicable taxes, interest, and penalties under the existing law and procedures. If only one party to a joint return consents to the amended join returns, the returns will not be processable. However, the case can be resolved by way of a Form 906, Closing Agreement, or a Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. Both Forms allow the disclosing taxpayer to consent to an assessment of the tax and interest owed.

This process is controversial. First, the IRS voluntary disclosure process only protects from criminal prosecution taxpayers that have been pre-cleared and accepted into the program. By entering the program, the disclosing taxpayer is protected while the other party remains open to criminal prosecution and penalties. The inculpated party may mitigate the adverse consequences of the disclosure by requesting relief from join and several liability on joint returns under I.R.C. § 6015. The request is filed using Form 8857, Request for Innocent Spouse Relief.

V. Conclusion

The attorneys at Agostino & Associates, P.C. have helped taxpayers, attorneys, accountants, and tax receivers dealing with tax issues in Sheridan disputes. If you have questions, please contact us.

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3 Id. at 563.
4 Id. at 556.
5 Id. at 561.
6 Id.
7 Id. at 561-562.
10 U.S. v. Cefalu, 85 F.3d 964, 970 (2d Cir. 1996)
11 U.S. v. Johnson, 546 F.2d 1225, 1227 (5th Cir. 1977).
13 Id. at 562.
14 N.J. Rules of Prof’l Conduct R. 1.6 (b)-(d).
16 N.J. Ct. R. 5:5-2(a) (emphasis added).
17 N.J. Ct. R. 5:5-2(c).
18 Id.
19 Id.
21 Id.
23 Id.
27 Requesting a Matrimonial Receivership to Cure your Sheridan Problem, AGOSTINO & ASSOCIATES MONTHLY J. OF TAX CONTROVERSY 3 (Dec. 2013) [hereinafter “Requesting a Matrimonial Receivership”].
28 Id.
29 Id.
30 Id.
31 Id.
32 Id.
35 Id.
36 Id.
37 Id.
38 Id.
39 Id.
40 Requesting a Matrimonial Receivership, supra at 29.
42 Id.
45 I.R.M., pt. 9.5.11.9(2) (Dec. 9, 2009).
46 Id.
47 Id. at (4).
49 Id.
50 VD Individuals, supra at 48.
51 Id.
52 Id.
53 N.J.S.A. § 54A:9-4(c)(3).