

## Tax Controversies: Audits, Investigations, Trials

## 15 Civil Penalties

**[1] Fraud Penalty in General**

*IRC Section 6663(a)* provides that if any part of an underpayment of tax required to be shown on a return is due to fraud, a penalty of 75 percent of the portion of the underpayment attributable to the fraud is imposed. n439 The accuracy-related penalty and the fraud penalty are coordinated with each other so that the accuracy-related penalty is inapplicable to that portion of the underpayment that is subject to the fraud penalty. n440 The fraud penalty, like the accuracy-related penalty, applies only when a return has actually been filed. n441 Where a failure to file is fraudulent, the taxpayer is subject to a higher delinquency penalty. n442

The Service bears the burden of proving the presence of fraud by clear and convincing evidence. n443 It should be noted that this is a lower standard of proof than is required in a criminal proceeding, which requires guilt to be established beyond a reasonable doubt. Accordingly, a taxpayer who has been acquitted of tax evasion in a criminal proceeding, can still be subject to the civil fraud penalty. n444 By similar logic, a taxpayer convicted of tax evasion in a criminal proceeding is foreclosed from contesting a civil fraud penalty. n445 Moreover, a criminal fine for fraud may not be used as a credit against the civil fraud penalty. Thus, the Ninth Circuit held that because criminal fines and the civil fraud penalty serve different congressional purposes, the Tax Court was correct in not allowing a credit against the civil fraud additions to tax for petitioner's \$250,000 criminal fine. n446 Once the Service establishes that a portion of an underpayment is attributable to fraud, the entire underpayment is deemed attributable to fraud unless the taxpayer proves by a preponderance of evidence that the underpayment (or portion thereof) is not attributable to fraud. n447 Special rules apply to joint returns which are discussed in detail below. n448

As discussed below, the distinction between fraud and negligence is not subject to ready description. One court has observed that "the line between the fraudulent and the careless, between the evil and the negligent is shadowy and elusive." n449 Indeed, in many cases the discretion of the Service may prove dispositive, in that mere negligence has been asserted in cases that seem to bear indicia of fraud, n450 while fraud has been asserted in cases on the borderline of negligence. n451 Numerous considerations discussed more fully herein, such as statutes of limitations n452 and burdens of proof, bear on the Service's decision to assert a particular penalty. Because of the magnitude of the fraud penalty, the Service often resorts to it as a potent device in negotiating a settlement.

**[2] Constitutionality**

The constitutionality of imposing a civil penalty for fraud has been upheld against the claim that it violates the principle of separation of powers by vesting in administrative officials the judicial power to impose punishment for crime. n453 The claim that imposing a fraud penalty on a taxpayer who has already been convicted of the crime of tax evasion for the same misconduct violates the *double jeopardy clause* also has been rejected. n454 The Supreme Court has held that the fraud penalty is not a criminal penalty but rather a civil sanction, designed "primarily as a safeguard for the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud." n455

**[3] Definition of Fraud**

The term "fraud" as used in Section 6663 is not defined in the Code or in the regulations. However, "fraud" has been defined by the courts as "actual intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing." n456 "Neither gross negligence nor mere suspicion of fraud will suffice" for imposition of the fraud penalty. n457 Rather, fraud "implies bad faith and a sinister motive."

n458 While fraud most commonly consists of a failure to report income, fraud penalties often have been assessed in cases involving excessive or improper deductions, n459 fraudulent increases in the basis of property sold at a gain, n460 overstatement of the cost of goods sold, n461 shifting income from the taxpayer to a family member, n462 reporting ordinary income as capital gain, n463 overstatement of withholding tax credits, n464 or any other fraudulent scheme to evade taxes. Since fraud implies deceit and deception, the fraud penalty does not apply to one, such as a tax protester, who makes no attempt to conceal the nonpayment of taxes, but rather calls the defiance of the tax laws to the attention of the Service, n465 nor to one who alerts the Service on a return of the omission of income. n466

Because an element of fraud requires a wrongful intent, which is very difficult to prove, certain factors are used by courts as indicia of fraud. For example, in a leading criminal tax fraud case, the Supreme Court stated, "[b]y way of illustration and not by way of limitation," that fraud

"may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal." n467

All the foregoing indicia of fraud have been recognized in civil fraud penalty cases as well as in criminal prosecutions. n468 Another factor often regarded as a badge of fraud is the taxpayer's attempt to mislead revenue agents conducting an audit or investigation. n469 The fraud necessary to sustain the penalty, however, is fraud existing during the tax year in issue or when the return was filed. Conduct performed years later, designed to obstruct the Service's investigation, even if reprehensible or criminal, will not support the fraud penalty if it is not probative of the taxpayer's state of mind during the tax year in issue. n470

The fraud penalty will not be imposed where the deficiency in taxes was due to an honest mistake, n471 an unsuccessful attempt at legitimate tax avoidance, n472 poor judgment, n473 "inefficiency and ignorance of accounting methods," n474 "or even gross negligence." n475 Even when the taxpayer's "education and sophistication would certainly justify the conclusion that he *should have* known better," that does "not constitute proof that he *did* know better, and, therefore, that his returns were fraudulent." n476 A taxpayer is not guilty of fraud if he believes in good faith that no taxes are owed, even if this belief is based on a totally inaccurate view of the law. n477 Moreover, fraud generally will not be found when a taxpayer in good faith relied on a third party to prepare and file his tax returns. n478 If, however, the taxpayer does not turn over to such party all relevant documentation and information, then fraudulent intent may be found. n479 Proof that the taxpayer's mental functioning was impaired will negate any finding of the requisite fraudulent intent. n480 While fraud "is never to be presumed," n481 a repeated pattern of large understatements of income over a number of years is "strong evidence" of fraud. n482 While a consistent pattern of underreporting of income is insufficient, standing alone, to support the imposition of the fraud penalty, n483 such evidence is sufficient if the taxpayer demonstrates bad faith by giving a "patently weak or incredible explanation" for the understatement of taxable income, n484 or if there is other evidence of fraud in the record. n485 However, the court's failure to believe the taxpayer's testimony, standing alone, is not sufficient to support the fraud penalty. n486 This is true, however, only where the existence of such underpayments can be proven by the Service by evidence that is sufficiently credible to meet its burden of proof on the fraud issue. n487 Thus, for example, if the taxpayer cannot meet his or her burden of disproving the Service's claims of additional tax, that is not enough for the Service to satisfy its burden of proving fraud. n488 And even if the Service offers evidence of unreported income, if this evidence consists of a net-worth reconstruction of dubious validity, n489 the courts will not find such evidence sufficient to find fraud. n490 The Service is prohibited from using financial status or economic related examination techniques to determine the existence of unreported income unless the Service has "a reasonable indication that there is a likelihood of such unreported income." n491 One factor considered by the Service in determining whether to impose a fraud penalty is the amount of the deficiency; if the tax due is diminutive, the fraud penalty usually will not be asserted. n492 The understatement of income or the overstatement of deductions will not support a charge of fraud if the taxpayer filed a return that contained enough information to alert the Service to the nature of the transaction, n493 because "[i]t is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of

reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its collection with interest for the delay." n494

#### **[4] Effect of Filing a Joint Return**

At one time, many courts held that if a husband and wife filed a joint return, each was jointly and severally liable for the fraud penalty if either one was guilty of fraud. n495 That harsh rule was changed by statute; the fraud penalty may now be assessed only on the spouse guilty of fraud. n496 If one spouse is liable for fraud, the imposition of the accuracy-related penalty under section 6662 on the other spouse would result in impermissible stacking. n497 Finally, although spouses filing a joint return are generally jointly and severally liable for the tax due on that return, n498 an innocent spouse, under certain circumstances, may seek relief from liability for the tax and interest as well as the penalty resulting from understatement of tax attributable to an erroneous item of the other spouse filing the joint return. n499

#### **[5] Effect of Taxpayer's Death**

The death of the taxpayer was thought at one time to terminate the liability of the deceased taxpayer's estate for the civil fraud penalty, though not for the underlying tax deficiency. n500 This was because the addition to tax for fraud was then considered punitive in nature. Criminal prosecutions terminate on the death of the defendant, n501 and when the defendant dies pending appeal, any fines imposed in the judgment of conviction may not be collected from the defendant's estate. n502 The same rule had long been applied to civil actions brought to recover penalties and forfeitures. n503 Since the fraud penalty was considered to be in the nature of a fine or punitive civil forfeiture, both the Service and the courts accepted that no fraud penalty could be assessed against the estate of a deceased taxpayer. n504

In 1940, the Service reversed its position, n505 following the Supreme Court's holding in *Helvering v. Mitchell* n506 that the fraud penalty is remedial rather than punitive in nature, being designed to reimburse the government for the expense of detecting fraud. That change in position was accepted by the courts, n507 and it is now well settled that the estate of a deceased taxpayer may be assessed the fraud penalty on account of the fraud of the decedent.

#### **[6] Comparison of Civil Fraud and Criminal Fraud**

Generally, it is well settled that the state of mind required for the imposition of the fraud penalty is identical to that which must be shown in a criminal prosecution for tax evasion under Section 7201. n508 A criminal conviction under Section 7201 requires a showing of "voluntary, intentional violation of a known legal duty." n509 An intent to defraud or to conceal income is insufficient where the defendant acted entirely for purposes other than evading federal taxes. n510 But "if the tax evasion motive plays any part in [the fraudulent] conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime." n511 Such a motive may be inferred if the taxpayer is proven to have known "that the tax is due and has not been paid." n512

While the states of mind required for a criminal conviction under Section 7201 and for imposition of the civil fraud are identical, it is not clear whether these two areas can be equated in all other respects. For example, a defendant who has the requisite specific intent to evade taxes can be convicted under Section 7201 only if he also commits some affirmative act of fraud or concealment; mere inaction (i.e., a simple failure to file a return and pay taxes without acts of evasion), even coupled with the specific intent to defraud, will support a conviction only of the lesser offense defined in Section 7203. n513 However, in the civil penalty area, a fraud penalty applies to a taxpayer who fraudulently fails to file a return. n514

Of course, civil and criminal fraud involve different burdens of proof. In a criminal prosecution, fraud must be proven by the government beyond a reasonable doubt. n515 In a civil fraud penalty proceeding, on the other hand, while the burden of proof is also on the government, fraud may be proven by "clear and convincing evidence," whether the penalty is litigated in the Tax Court n516 or in a refund suit in a district court. n517 However, in a civil penalty case, once the Service does prove the existence of some fraud-tainted deficiency, the burden is on the taxpayer to prove the correct amount of the total deficiency

upon which the fraud penalty will be computed. n518 If the taxpayer is unable to meet that burden by a preponderance of the evidence, the amount of deficiency asserted in the Commissioner's notice of deficiency will be accepted. n519 Because of the difference in the burden of proof, the Service will often assert the fraud penalty even after it has decided to discontinue a criminal investigation. n520

### **[7] Computation of the Penalty**

Section 6663(a) provides that a 75 percent penalty is imposed on any portion of an underpayment which is attributable to fraud. n521 As stated above, the Code provides that if the Service proves that any portion of an underpayment is attributable to fraud, the entire underpayment is deemed attributable to fraud, except for those portions of the underpayment which the taxpayer proves, by a preponderance of the evidence, are not due to fraud. n522 The legislative history makes clear, however, that this rule merely allocates the burden of proof, and that it is the intent of Congress that the 75 percent fraud penalty be applied only to those portions of the deficiency which are tainted by fraud. Because the fraud penalty is a percentage of the underpayment, even if the taxpayer has the necessary wrongful intent, if there is no actual underpayment, the penalty is not triggered. n523 In computing the amount of the underpayment, withholding and estimated taxes are not subtracted from the amount required to be shown on the return, n524 and the amount of the underpayment is determined without regarding to net operating loss carrybacks. n525 In general, subsequent events will not operate to reduce the amount of the fraud penalty. n526

#### **FOOTNOTES:**

(n1)Footnote 439. *IRC § 6663(a)*.

(n2)Footnote 440. *IRC § 6662(b)*. Similarly, the penalty for reportable transaction understatements of *IRC § 6662A* is inapplicable to any portion of an understatement on which the fraud penalty applies. *IRC § 6662A(e)(2)(A)*.

(n3)Footnote 441. *IRC § 6664(b)*.

(n4)Footnote 442. *IRC § 6651(f)*. The failure to file penalty is discussed in § 15.02.

(n5)Footnote 443. See discussion below at § 15.04[6].

(n6)Footnote 444. *Helvering v Mitchell, 303 US 391 (1938)* ; *McGee v Commr, T.C. Memo 2000-308* . See *Maciel v Commr, 489 F3d 1018 (9th Cir 2007)* (taxpayer pled guilty to criminal tax charges, but the sentencing court found no fraudulent intent; the Service could still impose the civil fraud penalty).

(n7)Footnote 445. See, eg, *Amos v Commr, 360 F2d 358 (4th Cir 1965)* . However, when a guilty plea in a criminal fraud case is prompted by outside factors not directly pertaining to the substance of the actual fraud claim, the guilty plea may not be controlling in a subsequent civil case. *Powers v Commr, TC Memo 1962-5* (poor health of the taxpayer); *Hendrick v Commr, TC Memo 1961-308* (lack of understanding due to little education). Moreover, a plea of *nolo contendere* is considered to be a mere statement of the taxpayer's unwillingness to contest the charges made against him and is not admissible evidence with respect to the issue of civil fraud. *Mickler v Fahs, 243 F2d 515 (5th Cir 1957)* . Similarly, a taxpayer's prior conviction for criminal tax evasion will not collaterally estop taxpayer from contesting, in a subsequent deficiency proceeding, the precise amount of the deficiency; although taxpayer's prior admission in a criminal prosecution as to the amount of unreported income constituted strong evidence, the precise amount of the deficiency was not a necessary element of the tax evasion conviction. *Uscinski v Commr, TC Memo 2006-200* . The foreclosure to challenge the civil fraud penalty applies only to the years for which the taxpayer is convicted. A conviction for a later year does not raise a presumption of civil fraud for an earlier year. *Corson v Commr, TC Memo 1965-214* .

(n8)Footnote 446. *Schachter v Commr, 255 F3d 1031 (9th Cir 2001)* (civil penalties for additions to tax are remedial in nature and are primarily imposed to reimburse the Government for investigation expenses, to cover the monetary loss due to the taxpayer's fraud, and to protect revenue, while criminal penalties are punitive in nature).

(n9)Footnote 447. *IRC § 6663(b)*; *Sadler v Commr*, 113 TC 99 (1999) . The IRS must prove the existence of fraud by clear and convincing evidence. *IRC § 7454(a)*; *Tax Court Rule 142(b)*; *Patton v Commr*, 799 F2d 166, 171 (5th Cir1986) . The presumption of correctness that attaches to a deficiency determination does not extend to the determination of fraud. *Est of Lisle v Commr*, 341 F3d 364 (5th Cir 2003) .

(n10)Footnote 448. *IRC § 6663(c)*. See § 15.04[4], *infra*.

(n11)Footnote 449. *Carter v Campbell*, 264 F2d 930, 941 (5th Cir 1959) .

(n12)Footnote 450. Eg, *Semel v Commr*, TC Memo 1965-232 (forged signature).

(n13)Footnote 451. Eg, *Owens v US*, 197 F2d 450 (8th Cir 1952) .

(n14)Footnote 452. Statutes of limitations are discussed in Ch 3.

(n15)Footnote 453. *Doll v Evans*, 7 F Cas 855, 857, 2 AFTR 2040 (CCEDPa 1872) .

(n16)Footnote 454. *Helvering v Mitchell*, 303 US 391, 399-405, (1938) (Brandeis, J); *Schachter v Commr*, 113 TC 192 (1999) . See also *Morse v Commr*, 419 F3d 829 (8th Cir 2005) (civil tax penalty for fraud was remedial, rather than punitive, and thus was not a criminal penalty for purposes of the *double jeopardy clause*); *Hudson v US*, 522 US 93 (1996) ; *Kennedy v Mendoza-Martinez*, 372 US 144, (1963) ; *Spies v. US*, 317 US 492 (1943) ; *Grimes v Commr*, 82 F3d 286 (9th Cir 1997) .

(n17)Footnote 455. *Id.*, at 401 (footnote omitted). But in *US v Halper*, 490 US 435 (1989) , the Supreme Court, distinguishing *Mitchell*, held that a civil penalty must bear some reasonable relationship to the government's pecuniary loss. The Court held unconstitutional, on double jeopardy grounds, the imposition of a civil penalty, under the civil provisions of the False Claims Act, 31 USC § 3729, against an individual who was previously convicted under the criminal provisions of the False Claims Act, 18 USC § 287. The civil penalty amounted to more than \$130,000 and the government's actual loss was only \$585. However, in post-*Halper* cases, courts have upheld the fraud penalty, in reliance on *Mitchell*, holding that, unlike the penalty at issue in *Halper*, the civil fraud penalty had a reasonable relationship to the amount of the government's loss. *McNichols v Commr*, 13 F3d 432, 434-36 (1st Cir 1993) ; *Barnette v Commr*, 95 TC 341 (1990) . Similarly, on occasion, specific tax or penalty provisions of the Code or of state tax statutes, have been stricken by the courts on the theory that they were punitive in purpose and not designed to raise revenue. Eg, *Dept of Rev of Montana v Kurth Ranch*, 511 US 767 (1994) (state "tax" on marijuana, applicable only to taxpayers who have been arrested for selling drugs, held to violate *double jeopardy clause*); *US v Dalton*, 960 F2d 121 (10th Cir 1992) (due process prohibits prosecution of taxpayer under *IRC § 5861(e)* for failure to pay transfer tax on machine gun, because possession of machine gun is illegal under 18 USC § 922(o), and the Service will therefore not accept payment of the transfer tax); *US v Glidden Co*, 78 F2d 639 (6th Cir 1935) ; *cert denied*, 296 US 652 , (penalty for violation of Prohibition laws); but *cf US v Sanchez*, 340 US 42 (1950) (tax on marijuana held valid).

(n18)Footnote 456. *Zell v Commr*, 763 F2d 1139, 1142-43 (10th Cir 1985) ; *Kellett v Commr*, 5 TC 608, 618 (1945) ; *accord Marcus v Commr*, 70 TC 562, 577 (1978) , *affd mem* 621 F2d 439 (5th Cir 1980) ; *Brown v Commr*, TC Memo 1977-138 ; *Ehlers v Vinal*, 382 F2d 58, 66 (8th Cir 1967) ; *Wiseley v Commr*, 185 F2d 263, 266 (6th Cir 1950) ; *Heninger v Commr*, 9 BTA 1318, 1320 (1928) .

(n19)Footnote 457. *Brown v Commr*, TC Memo 1977-138 , and cases cited therein. See also *Spitz v Commr*, 954 F2d 1382, 1384-86 (7th Cir 1992) ; *Dubravski v Commr*, TC Memo 1980-17 .

(n20)Footnote 458. *Shapolsky v Commr*, TC Memo 1971-37 . But see *US v Pomponio*, 429 US 10 (1976) (holding that in a criminal tax case the government need not establish any "bad purpose or evil motive" other than the intent to violate a known legal duty).

(n21)Footnote 459. Eg, *Scallen v Commr*, 877 F2d 1364, 1369 (8th Cir 1989) ; *Neaderland v Commr*,

52 TC 532 (1969) ; *McAlpine v Commr*, TC Memo 1984-162 ; *Simmons v Commr*, TC Memo 1980-55 ; *US v Goldstein*, 342 F Supp 661, 669 (EDNY 1972) (criminal prosecution; held a "deduction taken in bad faith is a tax fraud").

(n22)Footnote 460. Eg, *US v Krilich*, 470 F2d 341 (7th Cir 1972) (criminal prosecution).

(n23)Footnote 461. Eg, *Rich v Commr*, 6 BTA 822, 823 (1927) .

(n24)Footnote 462. Eg, *Coats v US*, 258 F Supp 1, 5 (ED Tex 1966) .

(n25)Footnote 463. Eg, *High v Commr*, TC Memo 1956-18 .

(n26)Footnote 464. Eg, *May v Commr*, 137 TC 147 (2011) .

(n27)Footnote 465. *Zell v Commr*, 763 F2d 1139, 1143-45 (10th Cir 1985) ; *Raley v Commr*, 676 F2d 980, 983-84 (3d Cir 1982) ; *Muste v Commr*, 35 TC 913, 921 (1961). *Contra*, *Granado v Commr*, 792 F2d 91, 92-94 (7th Cir 1986) ; *Martin v Commr*, TC Memo 1985-57 (fraud penalty imposed on tax protester who filed false withholding certificates with his employer).

(n28)Footnote 466. *Peters v US*, 574 F Supp 37, 40 (ED Wis 1983) . See also *Jemison v Commr*, 45 F2d 4, 6 (5th Cir 1930) ; *Fox v Commr*, 61 TC 704, 718-19 (1974) ; *Dilks v Commr*, 15 BTA 1294, 1301 (1929) (understatement of income or the overstatement of deductions does not support a fraud charge if the taxpayer filed a return that contained enough information to alert the Service to the nature of the transaction).

(n29)Footnote 467. *Spies v US*, 317 US 492, 499 (1943) . See also *Morse v Commr*, 419 F3d 829 (8th Cir 2005) (the criminal conviction-together with consistent underreporting of income, lack of a satisfactory explanation, and failure to provide the tax preparer with complete information-provided a substantial body of evidence to support the tax court's finding of fraud).

(n30)Footnote 468. See *Cole v Commr*, 637 F3d 767, 780 (7th Cir 2011) ; *Est of Kanter v Commr*, 337 F3d 833 (7th Cir 2003) ; *Scallen v Commr*, 877 F2d 1364, 1370 (8th Cir 1989) ; *Bradford v Commr*, 796 F2d 303, 307-308 (9th Cir 1986) ; *Loftin & Woodward v US*, 577 F2d 1206, 1238-39 (5th Cir 1978) ; *Miller v Commr*, 94 TC 316, 334 (1990) ; *Meier v Commr*, 91 TC 273 (1988) ; *Norris v Commr*, TC Memo 2011-161 ; *Green v Commr*, TC Memo 2010-109 . See also IRM 20.1.5.12.1 (7-1-08); IRM 25.1.6.3 (10-30-09).

(n31)Footnote 469. See, eg, *Zell v Commr*, 763 F2d 1139 (10th Cir 1985) ; *Dereco Inc v Commr*, TC Memo 2000-279 ; *Davis v Commr*, TC Memo 1999-250 ; *Fason v Commr*, TC Memo 1999-405 ; *Compact Equipment Co. v Commr*, TC Memo 1999-409 ; *Sherman v Commr*, TC Memo 1977-261 . *Quinn v Commr*, TC Memo 2012-178 , presents a stark case in which the taxpayer, an employee of the IRS, presented altered or fabricated documentation and otherwise obstructed an investigation into her taxes. But see *McAlpine v Commr*, TC Memo 1984-162 (potentially misleading statements were made "off the record" and agents did not request a second interview to provide taxpayer an opportunity to explain or otherwise clear up discrepancies). On the other hand, maintenance of complete and accurate records is an indication that the underpayment was not fraudulent. *Dagon v Commr*, TC Memo 1984-138 . *Ferry v Commr*, TC Memo 1984-229 .

(n32)Footnote 470. *Gleis v Commr*, 24 TC 941 (1955) ; *Barrier v Commr*, TC Memo 1983-258 .

(n33)Footnote 471. *Delone v Commr*, 100 F2d 507, 509 (3d Cir 1938) ; *Cohen v Commr*, 27 TC 221, 229-30 (1956) ; *Norris v Commr*, TC Memo 2011-161 (2011) ; *Taylor v Commr*, TC Memo 1997-513 (company books in disarray did not evince an intent to defraud); *Tessers v Commr*, TC Memo 1966-172 (immigrant taxpayer did not know that taxes were owing on sweepstakes winnings).

(n34)Footnote 472. *Loftin & Woodward v US*, 577 F2d 1206, 1238 n.89 (5th Cir 1978) ; cf Ch 5 discussion of criminal versus civil tax cases.

(n35)Footnote 473. *Iley v Commr*, 19 TC 631, 635 (1952) . *Iley* was overruled on another issue in *Hughes v Commr*, 22 TC 1, 4 (1954) .

(n36)Footnote 474. *Marinzulich v Commr*, 31 TC 487, 490 (1958) . See also *Candela v US*, 635 F2d 1272, 1275 (7th Cir 1980) ; *Bisceglia v Commr*, TC Memo 2002-22 ; *Beck v Commr*, TC Memo 2001-270 .

(n37)Footnote 475. *Mitchell v Commissioner*, 118 F2d 308, 310 (5th Cir 1941) ; *Ferguson v Commr*, 14 TC 846, 849 (1950) ; *Brown v Commr*, TC Memo 1977-138 ; *Gagliardi v US*, 81 Fed Cl 772 (2008) ("benign ineptitude" insufficient to prove fraud).

(n38)Footnote 476. *Id* (emphasis in original). Nevertheless, the personal attributes of the taxpayer are relevant in determining the issue of civil fraud, just as they are in determining whether the taxpayer should be charged with criminal fraud. *US v Walton*, 909 F2d 915, 927 (6th Cir 1990) ; *Scallen v Commr*, 877 F2d 1364, 1371-72 (8th Cir 1989) ; *Fried v Commr*, TC Memo 1989-430 . See Ch 5.

(n39)Footnote 477. *Johnson v Commr*, TC Memo 1998-275 (taxpayer incorrectly believed that his net income was insufficient to generate a duty to file a return; penalty not imposed); *Taylor v Commr*, TC Memo 1997-513 (parolee unaware that check kiting scheme generated taxable income; revenue officer failed to recognize issue;no penalty imposed); *Wiggins-El v Commr*, TC Memo 1981-495 (taxpayer was advised by leaders of her church that church members were exempt from tax); *Hicks v Commr*, TC Memo 1979-98 (taxpayer believed income tax unconstitutional), *affd mem* 614 F2d 1295 (5th Cir 1980) . See also Ch 18.

(n40)Footnote 478. *Eg*, *Shokai Inc, Alexander v Commr*, 34 F3d 1480 (9th Cir 1994) ; *Eagle v Commr*, 242 F2d 635 (5th Cir 1957) ; *Kaissy v Commr*, TC Memo 1994-474 ; Litigation Guideline Memorandum TL-32 (1/22/88).

(n41)Footnote 479. *Eg*, *Morse v Commr*, 419 F3d 829 (8th Cir 2005) ; *McGraw v Commr*, 384 F3d 965 (8th Cir 2004) ; *Korecky v Commr*, 781 F2d 1566 (11th Cir 1986) ; *Olbres v Commr*, TC Memo 1997-437 ; *Houser v Commr*, TC Memo 1995-330 .

(n42)Footnote 480. *Wilson v Commr*, 76 TC 623 (1981) ; *Gutierrez v Commr*, TC Memo 1995-252 (taxpayer in alcoholic haze); *Chandler v Commr*, TC Memo 1990-421 (same); *Simonelli v Commr*, TC Memo 1985-12 (mental incapacity).

(n43)Footnote 481. *Zell v Commr*, 763 F2d 1139, 1143 (10th Cir 1985) ; *Toussaint v Commr*, 743 F2d 309 (5th Cir 1984) ; *Vallone v Commr*, 88 TC 794, 816 (1987) ; *Brown v Commr*, TC Memo 1977-138 .

(n44)Footnote 482. *Otsuki v Commr*, 53 TC 96, 107 (1969) ; *Marcus v Commr*, 70 TC 562 (1978) ; *US v Procaro*, 356 F2d 614, 618 (2d Cir 1966) (criminal prosecution); *Epstein v US*, 246 F2d 563, 566 (6th Cir 1957) (same); *In re Ryan*, 286 BR 141, 148 (Bankr WD Mo 2002) (repeated significant understatements of income is "badge[] of fraud"); *Hill v Commr*, TC Memo 1997-425 ; *Inner City Temp Inc v Commr*, TC Memo 1990-489 .

(n45)Footnote 483. *Loftin & Woodard, Inc v US*, 577 F2d 1206 (5th Cir 1978) (a consistent and substantial understatement of income is insufficient, by itself, to support a finding of fraud); *Pappas v Commr*, TC Memo 1981-639 (court refused to impose the fraud penalty because the IRS cannot meet its burden of proof on the mere basis of the taxpayer's failure to discharge his burden of proof with respect to deficiencies); *Toledano v Commr*, 362 F2d 243, 247 (5th Cir 1966) ; *US v Mitchell*, 271 F Supp 858, 863 (ND Ill 1967) , *affd on other grounds* 413 F2d 181 (7th Cir 1969) ; *Terrel Equipment Co v Commr*, TC Memo 2002-58 ; *Cooper v Commr*, TC Memo 1990-237 ; *Poor v Commr*, TC Memo 1984-3 ; *Vento v Commr*, TC Memo 1984-6 ; *Dagon v Commr*, TC Memo 1984-138 ; *Marcus v Commr*, 70 TC 562 (1978) ; *Revader v Commr*, TC Memo 1980-473 ; *Kendzie v Commr*, TC Memo 1968-174 . See also *Fulp v Commr*, TC Memo 1978-382 . But *cf Est of Briden v Commr*, 11 TC 1095, 1134-35 (1948) , *affd on other grounds sub nom Kirk v Commr*, 179 F2d 619 (1st Cir 1950) .

(n46)Footnote 484. *Adler v Commr*, 422 F2d 63, 67 (6th Cir 1970) . See also *Estes v*

*Commr, TC Memo 1984-636* .

(n47)Footnote 485. *Eg, Merritt v Commr, 301 F2d 484, 487 (5th Cir 1962)* (taxpayer's books and records inaccurate); *Marcus v Commr, 70 TC 562 (1978)* (taxpayer's books and records inadequate; taxpayer altered checks and made false statement to revenue agent); *Roth v Commr, TC Memo 1998-28* (failure to produce receipts and records regarding advertising sales); *Roose v Commr, TC Memo 1995-585* (taxpayers who operated a drug store failed to report receipts from credit card sales, coupon redemptions and payments from insurance companies). See also *McGraw v Commr, 384 F3d 965, 971 (8th Cir 2004)* (the argument by controlling shareholder that his intent was "only" to evade his personal income taxes and not taxpayer's corporate taxes supported a finding of fraudulent intent--a concession with regard to individual taxes is "pregnant with the admission" that there existed a similar intention with respect to corporate taxes); *Conti v Commr, 39 F3d 658 (6th Cir 1994)* (evidence that taxpayer's understatements of income resulted from fraud was bolstered given taxpayers' implausible and undocumented allegations regarding sources of large amounts of cash, their extensive dealings in cash, and their large understatements of income); *Koscove v Commr, 225 F2d 85, 87 (10th Cir 1955)* (taxpayers' admission that their understatement of income was for the purpose of misleading local tax authorities and evading local taxes further supported a finding of fraud); *Hecht v Commr, 16 TC 981, 987 (1951)* (finding fraud where taxpayer claimed he intended to deceive employer rather than IRS, but knew his actions would necessarily deceive government officials as well).

(n48)Footnote 486. *Driehorg v Commr, 225 F2d 216, 218 (6th Cir 1955)* ; *Petzoldt v Commr, 92 TC 661, 700 (1989)* ; *Habersham-Bey v Commr, 78 TC 304, 312 (1982)* ; *Otsuki v Commr, 53 TC 96, 107 (1969)* ; *Houser v Commr, TC Memo 1995-330* ; *DeClerq v Commr, TC Memo 1982-386* .

(n49)Footnote 487. Burden of proof on the issue of civil fraud is discussed in § 15.04[6], *infra*.

(n50)Footnote 488. *Anastasato v Commr, 794 F2d 884, 888-89 (3d Cir 1986)* ; *Petzoldt v Commr, 92 TC 661, 700 (1989)* ; *Habersham-Bey v Commr, 78 TC 304, 312 (1982)* ; *Otsuki v Commr, 53 TC 96, 107 (1969)* ; *Barrier v Commr, TC Memo 1983-258* ; *DeClerq v Commr, TC Memo 1982-386* ; *Dubravski v Commr, TC Memo 1980-17* ; *Diehl v Commr, TC Memo 1982-23* ; *Sullivan v Commr, TC Memo 1985-217* ; *cf Cipparone v Commr, TC Memo 1985-234* .

(n51)Footnote 489. See Ch 19, *infra*.

(n52)Footnote 490. *Candela v US, 635 F2d 1272, 1273-74 (7th Cir 1980)* .

(n53)Footnote 491. *IRC § 7602(e)*. This provision is effective as of July 22, 1998. Prior to the enactment of Section 7602(e), where a revenue agent confronted a taxpayer with a low gross income who was obviously living well, the agent was allowed to ask financial status questions pertaining to the taxpayer's lifestyle.

(n54)Footnote 492. *IRM 4.23.9.6 (5-14-08)* (Employment Tax Handbook).

(n55)Footnote 493. *Jemison v Commr, 45 F2d 4, 6 (5th Cir 1930)* ; *Fox v Commr, 61 TC 704, 718-19 (1974)* ; *Clark v Commr, TC Memo 1986-586* (taxpayer did not supply any dollar amounts on return on *Fifth Amendment* grounds but supplied the Service all information necessary to locate him; fraud penalty not imposed); *Froeber v Commr, TC Memo 1984-139* (tax protester did not report wage income on Form 1040 but did attach Form W-2 to the return; no penalty imposed); *Dilks v Commr, 15 BTA 1294, 1301 (1929)* . See also *Tavlian v Commr, TC Memo 1992-600* .

(n56)Footnote 494. *Spies v US, 317 US 492, 496 (1943)* .

(N57)Footnote 495. *Eg, Boyett v Commr, 204 F2d 205, 209 (5th Cir 1953)* .

(n58)Footnote 496. *IRC § 6662(b)*; *Garcia v Commr, TC Memo 2012-155* .

(n59)Footnote 497.

(n60)Footnote 498. *IRC § 6013(d)(3)*; *Gordon v US 757 F2d 1157 (11th Cir 1985)* .

(n61)Footnote 499. *IRC § 6015(a)*; see Chapter 15A. *IRC § 6015* provides relief only from joint and several liability arising from a joint return. If an individual signs a joint return under duress, the election to file jointly is not valid, there is no valid joint return, and therefore no joint and several liability. *Treas. Reg. § 1.6013-4(d)*.

(n62)Footnote 500. *Natl City Bank of New York Exr v Commr*, 35 BTA 975, 988 (1937) , *affd* 98 F2d 93 (2d Cir 1938) ; see also authorities cited in *Est of Reimer v Commr*, 12 TC 913, 916 (1949) , *affd* 180 F2d 159 (6th Cir 1950) .

(n63)Footnote 501. Eg, *US v Mollica*, 849 F2d 723, 725-26 (2d Cir 1988) ; *US v Pauline*, 625 F2d 684 (5th Cir 1980) ; *US v Moehlenkamp*, 557 F2d 126 (7th Cir 1977) . But cf, *US v Dwyer*, 654 F Supp 1254 (MD Pa 1987) .

(n64)Footnote 502. *US v Oberlin*, 718 F2d 894, 895 (9th Cir 1983) ; *US v Pauline*, 625 F2d 684 (5th Cir 1980) ; *Crooker v US*, 325 F2d 318, 321 (8th Cir 1963) .

(n65)Footnote 503. Eg, *Schreiber v Sharpless*, 110 US 76, (1884) (civil penalties for copyright infringement). Cf *US v Oberlin*, 718 F2d 894 (9th Cir 1983) (criminal forfeiture).

(n66)Footnote 504. See authorities cited in *Est of Reimer v Commr*, 12 TC 913, 916 (1949) , *affd* 180 F2d 159 (6th Cir 1950) .

(n67)Footnote 505. *Id.*

(n68)Footnote 506. 303 US 391 (1938) .

(n69)Footnote 507. *Est of Reimer v Commr*, 12 TC 913, 916 (1949) , *affd* 180 F2d 159 (6th Cir 1950) ; *Est of Briden v Commr*, 11 TC 1095, 1135-37 (1948) , *affd on other grounds sub nom Kirk v Commr*, 179 F2d 619 (1st Cir 1950) ; *Rev Rul 73-293*, 1973-2 CB 413 ; *US v Bushlow*, 832 F Supp 574 (EDNY 1993) (fraud penalty could be assessed after husband's death; however, penalty could not be collected from the proceeds of husband's life insurance policy that was paid to the wife (other than the cash surrender value) even though policy was purchased after the assessment, and assuming no showing of a fraudulent conveyance).

(n70)Footnote 508. Eg, *Kahr v Commr*, 414 F2d 621, 627 (2d Cir 1969) and cases cited therein. The collateral estoppel effects of a criminal conviction on the civil fraud penalty are discussed in Ch 22. The criminal penalty for tax evasion is considered in Ch 16.

(n71)Footnote 509. See *US v Pomponio*, 429 US 10, 12 (1976) .

(n72)Footnote 510. *Ingram v US*, 360 US 672 (1959) (defendants concealed gambling operation to avoid prosecution under state law, not to evade federal gambling excise tax; convictions of conspiracy to violate *IRC § 7201* reversed); *Kuhl v Commr*, TC Memo 1988-446 (taxpayer filed a "Fifth Amendment" return with the word "Object" in pertinent spaces; held, taxpayer was not motivated by a desire to evade tax but rather by a fear of self incrimination); *Jackson v Commr*, TC Memo 1981-252 (civil fraud penalty not imposed; taxpayer conducted a narcotics business in cash, maintained no records, and failed to list his occupation on his tax return in order to avoid prosecution under the narcotics law, rather than for the purpose of concealing taxable income); *Capp v Commr*, TC Memo 1968-53 (no civil fraud penalty where taxpayer intended to defraud employer but believed embezzled funds not taxable income); *Liddy v Commr*, TC Memo 1985-107 , *affd* 808 F2d 312 (4th Cir 1986) (taxpayer destroyed records as part of Watergate coverup, not to conceal taxes from Service).

(n73)Footnote 511. *Spies v US*, 317 US 492, 499 (1943) . See also *Guinan v Commr*, TC Memo 1991-190 (fact that assets which were hidden from wife whom taxpayer intended to divorce did not negate fraudulent intent); *Craddock v Commr*, TC Memo 1968-164 (the fact that kickbacks were not reported so taxpayer could save his job did not negate finding of fraud).

(n74)Footnote 512. *US v DeNiro*, 392 F2d 753, 758 (6th Cir 1968) , cert denied, 393 US 826, .

(n75)Footnote 513. *Spies v US*, 317 US 492, 499 (1943) .

(n76)Footnote 514. *IRC § 6651(f)*. Under prior law, some courts held that the fraud penalty could be imposed on a taxpayer who failed to file a return if the taxpayer had the specific intent to defraud, even if the taxpayer committed no affirmative acts of fraud. *Kahr v Commr*, 414 F2d 621, 625-26 (2d Cir 1969) ; *Powell v Granquist*, 252 F2d 56, 59-61 (9th Cir 1958) ; *Guinn v Commr*, TC Memo 1983-401 ; *Cirillo v Commr*, TC Memo 1961-192 , affd in part revd in part on other grounds sub nom *Cirillo v Commr*, 314 F2d 478 (3d Cir 1963) . See also *Paddock v Commr*, TC Memo 1985-586 and *Hudgens v Commr*, TC Memo 1985-587 (both discuss these two competing standards). The better view was that some affirmative act also was required to impose the civil fraud penalty. See *Zell v Commr*, 763 F2d 1139, 1143, 1145-46 (10th Cir 1985) (mere failure to file not sufficient to impose fraud penalty, but penalty could be imposed on taxpayer who filed false withholding certificate); *Solomon v Commr*, 732 F2d 1459, 1461-62 (6th Cir 1984) ; *First Trust & Sav Bank v US*, 206 F2d 97 (8th Cir 1953) ; *Jones v Commr*, 259 F2d 300 (5th Cir 1958) ; *Miller v Commr*, 94 TC 316, 335-37 (1990) (nonfiling of returns, even over a long period of time, is not subject to the fraud penalty; but failure to file accompanied by the affirmative act of filing false Forms W-4 to prevent withholding did justify imposition of the fraud penalty); *Kotmair v Commr*, 86 TC 1253, 1260-62 (1986) ; *Wolk v Commr*, TC Memo 1985-112 ; *Rowlee v Commr*, 80 TC 1111, 1123-25 (1983) ; *Thomas v Commr*, Memo 1984-72; *Piazza v Commr*, TC Memo 1978-422 ; *Bolden v Commr*, TC Memo 1978-294 ; *Grosshandler v Commr*, 75 TC 1, 19-20 (1980) .

(n77)Footnote 515. *Holland v US*, 348 US 121 (1954) .

(n78)Footnote 516. *Henson v Commr*, 887 F2d 1520, 1525 (11th Cir 1989) ; *Scallen v Commr*, 877 F2d 1364, 1369 (8th Cir 1989) ; *Solomon v Commr*, 732 F2d 1459 (6th Cir 1984) ; *Switzer v Commr*, 20 TC 759, 764 (1953) ; *Arlette Coat Co v Commr*, 14 TC 751, 756 (1950) ; *Wiseley v Commr*, 185 F2d 263, 266 (6th Cir 1950) ; *Rule 142(b)*, *Rules of Practice and Procedure, US Tax Court*. See *Larchmont Foundation v Commr*, 72 TC 131, 139 (1979) . In *Spitz v Commr*, 954 F2d 1382, 1383-84 (7th Cir 1992) , the court applied the "clear and convincing" standard, but suggested in dictum that this standard might be re-examined in light of recent cases permitting securities fraud and bankruptcy fraud to be proven merely by a preponderance of the evidence. This discussion, however, overlooked the fact that the legislative history of the 1989 revision of the penalty provisions clearly demonstrates that Congress specifically approved the "clear and convincing" standard for civil tax fraud cases. See HR Rep No 101-247, 101st Cong. 1st Sess at 1392 (1989).

(n79)Footnote 517. *Paddock v US*, 280 F2d 563 (2d Cir 1960) . Such "clear and convincing" evidence, however, may be entirely circumstantial, because direct proof of a taxpayer's state of mind is rarely available. *Cooperberg v Commr*, TC Memo 1979-102 and cases cited therein; *Gardiner v Commr*, TC Memo 1979-364 and cases cited therein. It has been held that the Service's burden may be satisfied through allegations in its Tax Court pleadings which are not denied by the taxpayer, eg, *Cassidy v Commr*, 814 F2d 477, 481-82 & n 3 (7th Cir 1987) , or which the taxpayer failed to contest by not appearing at trial. *Smith v Commr*, 91 TC 1049 (1988) , affd 926 F2d 1470 (6th Cir 1991) . This rule was questioned in dictum in *Rechtzigel v Commr*, 703 F2d 1063, 1064 n 2 (8th Cir 1983) , and the *Smith* case resulted in several sharp dissents in the Tax Court; see 91 TC 1049, 1062-69 (1988) . On appeal *Smith* was affirmed solely on the narrow ground that the taxpayer's failure to contest the case justified the entry of a default judgment. 926 F2d 1470 (6th Cir 1991) . See also *Vallone v Commr*, 88 TC 794, 815-16 (1987) (Tax Court granted partial summary judgment to Commissioner, holding that checks payable to taxpayers representing unreported income were admissible, but declined to grant summary judgment on the issue of the fraud penalty; question of whether receipt of unreported income was due to fraud involves inferences as to motive and intent which are inappropriate for summary judgment and can be "drawn only at trial").

(n80)Footnote 518. *IRC § 6663(b)*.

(n81)Footnote 519. *IRC § 6663(b)*.

(n82)Footnote 520. See IRM 25.1.1.2.2. (5-19-99).

(n83)Footnote 521. Prior to 1986, the fraud penalty was only 50 percent of the underpayment, however, under prior law the penalty was imposed on the entire amount of the underpayment--even the portion of the underpayment not attributable to fraud. *IRC § 6653(b)(c) (1954 Code)*; *Scallen v Commr, 877 F2d 1364 (8th Cir 1989)* . In addition to the fraud penalty, under prior law, an additional penalty was also imposed equal to one-half the interest due on that portion of the deficiency attributable to fraud. Former *IRC § 6601*. This additional penalty was repealed in 1988.

(n84)Footnote 522. *IRC § 6663(b)*.

(n85)Footnote 523. *Jenkins v US, 313 F2d 624 (5th Cir 1963)* .

(n86)Footnote 524. *Doraman v Commr, TC Memo 1986-203* .

(n87)Footnote 525. *Simon v Commr, 248 F2d 869 (8th Cir 1957)* .

(n88)Footnote 526. *Elmbrook Home v US, 559 F Supp 787 (D RI 1983)* (where § 1341 claim of right adjustment that requires a recomputation of a prior year's taxes, which effectively reduced the amount of this underpayment to zero, did not reduce or eliminate the amount of the fraud penalty).