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Burden of Proof for the Fraud Penalty

When imposing a fraud penalty related to the underpayment of taxes, the Commissioner of Internal Revenue must show that the taxpayer willfully intended to defraud the government. Past court cases provide guidance on the badges of fraud that help identify or indicate fraudulent behavior.

If a taxpayer has inaccuracies or misstatements on a tax return, the Commissioner of Internal Revenue may impose penalties in addition to levying the correct tax plus interest. Internal Revenue Code (IRC) §6662 provides an accuracy-related penalty on underpayments, and IRC §6663 allows the imposition of a fraud penalty. If any portion of the underpayment is due to fraud, the penalty is another 75% of the underpayment. If the Commissioner demonstrates that at least part of the underpayment is due to fraud, then all of the underpayment is treated as due to fraud unless the taxpayer demonstrates otherwise.

The Burden of Proof

In most circumstances, the taxpayer has the burden to show the right to claim a deduction or exclude an income item. If the taxpayer can't support the position, the deduction is disallowed or the revenue is taxed. In contrast, the burden of proof for fraud is initially on the Commissioner to show that the taxpayer intended to defraud the government.

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) consolidated several penalties into the accuracy penalty of IRC §6662 and simplified the administration. The committee report for that law records that Congress wanted the burden of proof for fraud placed on the Commissioner: "The committee has not altered the present-law burden of proof imposed on the IRS in establishing fraud initially; the IRS must continue to meet its burden of proof by clear and convincing evidence. The committee believes that it is appropriate that the burden imposed on the IRS be higher than the burden imposed on a taxpayer in these circumstances."

The American Jobs Creation Act of 2004 (P.L. 108-357) provided a safe harbor for taxpayers. The law states that there is no penalty under IRC §6662 or §6663 for any portion of an underpayment if the taxpayer shows that there was a reasonable cause for the underpayment and that he or she acted in good faith. To do that, the transaction that caused the underpayment of tax must be disclosed on the return, there must be substantial authority for the tax treatment, and the taxpayer must have a reasonable belief that it was the proper treatment [IRC §6664(d)(3)].

The Badges of Fraud

The Commissioner has a two-prong test to impose the fraud penalty of IRC §6663: (1) show an underpayment of tax, and (2) establish that a portion of it is due to fraud. To show fraud, the Commissioner must show that the taxpayer intended to defraud the government.

Since there aren't any published Treasury Regulations for IRC §6663, interpretation and examples come from court cases. In *Maciel v. Commissioner* (489 F.3d 1018, CA9, 2007), the court said: "In a civil tax case, the Commissioner of Internal Revenue bears the burden of proving fraud by clear and convincing evidence… The existence of fraud need not be shown by direct evidence; instead, a court may infer fraud from the existence of certain 'badges of fraud.'"

"Badges of fraud" is a loose term used to identify indicators of fraudulent activity. The Commissioner uses these badges to demonstrate the taxpayer's intent. They may include circumstantial or direct evidence (*Roye v. Commissioner*, TC Memo 2012-246). Because it's fraud, direct evidence is often difficult to come by. There also is no bright-line test to show fraud—one clear and convincing act may indicate fraud, or the court may require several.

Many court cases reference these badges. *Parks v. Commissioner* (94 TC 654), for example, involves a taxpayer who claimed that unreported income came from child support, which is nontaxable income. The first condition of the two-prong test was satisfied when that claim was disproved. The second condition was met when the Commissioner established that the taxpayer structured cash transactions to avoid filing reports, created and filed false documents, concealed assets, provided inconsistent explanations, and failed to cooperate with the tax officials. The taxpayer also failed to cooperate with the investigation, which didn't help her case. Leaving income off the tax return wasn't enough to establish fraud by itself. While it may look suspicious, it didn't substantiate a willful intent to mislead. In this case, there wasn't a single, specific item or action that swayed the court to rule against the taxpayer; rather, it was her combined actions that convinced the court that she willfully committed fraud.

Other cases reference how these badges have been applied. *Spies v. United States* (63 S. Ct. 364, 1943) lists examples of what courts view as willful attempts at fraud. This list includes, but is not limited to, keeping an extra set of books, making incorrect entries, creating false invoices, destroying the books, covering up income sources, avoiding entries, or anything else that could be viewed as misleading. The taxpayer in *Spies* was indicted for willfully attempting to evade tax and willfully failing to file a return.

The court also stated in *Spies* that the slight "inference of willful attempt" is still considered fraud. This provides some leeway in determining if fraud exists. "Inference of willful attempt" is an abstract phrase that inherently allows for drawing one's own conclusions as opposed to a concrete term that implies specific conditions that need to be met in order to reach the conclusion that fraud was committed.

Because tax evasion is a type of fraud, certain activities are also considered indicators of fraud for the two-prong test. In *Morse v. Commissioner* (419 F.3d 829, CA8, 2005), tax evasion was defined as, but not limited to, intentionally concealing evidence, using misleading facts, or otherwise preventing the government from collecting its taxes.

Morse involved three badges to establish fraud. First, the taxpayer omitted income for four consecutive tax years, saying that he forgot to give the information to his accountant. The second badge was withholding information from his tax preparer. And the third badge was that the taxpayer was previously convicted of filing false returns. That's a pretty big red flag and a giant check mark in the burden of proof column.

Another case that involved a taxpayer who concealed information from his tax preparer is *Marretta v. Commissioner* (168 Fed. Appx. 528, CA3, 2006). The central theme underlying *Marretta* is the taxpayer's omission of income from a Ponzi scheme. The taxpayer attempted to falsely claim distributions received from the scheme as a return of capital instead of receipt of income and withheld information about income from his tax preparer. This is viewed as intent to conceal and was used as a badge of fraud. Marretta later admitted to willfully evading tax, which was also used as a badge of fraud.

As these examples show, the combination of the badges/indicators/factors in each individual scenario makes or breaks a case. The more evidence the Commissioner can compile against a potential tax evader, the better and stronger the case for proving fraud. **SF**

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