

THE CRITERIA THE TAX COURT USES IN DETERMINING IF THE TAXPAYER IS LIABLE FOR THE FRAUD PENALTY

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TABLE OF CONTENTS

I. Introduction	445
II. Burden of Proof	446
III. Cases in Which the IRS Did Not Prove Fraud	446
IV. Factors Indicating Fraud	448
A. A Pattern of Underpaying Taxes	448
B. Poor Records and Frequent Cash Transactions	449
C. The Taxpayer's Business Ability	451
D. The Taxpayer's Failure to Cooperate	453
E. Conviction Under Criminal Tax Statutes	455
V. Conclusion	456

I. INTRODUCTION

Many people deliberately understate their tax liability, either by under-reporting income or over-reporting deductions.¹ According to an experienced practitioner: "A lot of noncompliance is not in a grey area; taxpayers know what they are doing is wrong."² In order to discourage this behavior, the federal tax laws contain a civil fraud penalty provision.³ For returns due prior to 1987, this penalty is the sum of: (1) 50% of the underpayment of tax due, and (2) 50% of the interest since the due date of the return (without extensions).⁴ For returns due after 1986, the penalty has been increased from 50% to 75% by the 1986 Tax Reform Act.⁵ Thus, the fraud penalty has become even more important.

In this article I examine several recent tax court cases in order to determine the criteria the court uses in deciding whether the penalty should be assessed. Although the court uses a facts and circumstances test, a careful

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1. *TAX NOTES*, April 25, 1988, at 429.

2. *Id.*

3. I.R.C. § 6653(b) (1985).

4. *Id.*

5. I.R.C. § 6653(b) (1987).

examination of these cases reveals certain helpful guidelines.

II. BURDEN OF PROOF

The fraud penalty statute is brief. Basically, it specifies the amount of the penalty for underpayment of federal taxes due to fraud.⁶ The tax court has developed case law on the allocation of the burden of proof on the showing which must be made for the IRS to prevail. The burden of proof is on the IRS, and it must prove, by clear and convincing evidence, that there is an underpayment of tax for each year in question, and that some part of the underpayment is due to fraud.⁷ If the IRS succeeds in carrying this burden of proof, the penalty is applied to the entire amount of the underpayment for that year.⁸ Thus, the exact amount of the underpayment due to fraud is irrelevant and need not be proven.⁹ For example, if the IRS proves that the taxpayer underpaid his or her taxes by \$2,000, and that part of this underpayment was due to fraud, the fraud penalty is applied to the full \$2,000.

Fraud is a matter of intent.¹⁰ It is, in this context, the intent to evade a tax believed to be owing "by conduct calculated to conceal, mislead, or otherwise prevent the collection of such taxes."¹¹ Since the intent of the taxpayer is not subject to direct proof, his or her entire course of conduct must be examined by the court.¹² If the IRS proves that the taxpayer committed fraud, no statute of limitations applies.¹³ If the IRS fails to prove fraud, the deficiency due to the underpayment stands unless the taxpayer proves, by a preponderance of the evidence, that the deficiency is incorrect.¹⁴ If the taxpayer cannot prove the deficiency is incorrect, and the IRS cannot prove fraud, then the IRS must assess the taxpayer within the time established by the statute of limitations for the assessment to be valid.¹⁵ Most fraud cases recite some or all of the above well-established principles.¹⁶

III. CASES IN WHICH THE IRS DID NOT PROVE FRAUD

Examination of three cases in which the IRS did not meet its burden helps clarify the effect of the burden of proof. Mere suspicion that the tax-

6. *Id.*

7. *Mosteller v. Commissioner*, 52 T.C.M. (CCH) 758, 761-63 (1986).

8. I.R.C. § 6653(b)(2) (1987).

9. *Mosteller v. Commissioner*, 52 T.C.M. (CCH) at 763.

10. *Id.* at 762.

11. *Id.*

12. *Id.* at 763.

13. I.R.C. § 6501(c)(1) (1987).

14. *Mosteller v. Commissioner*, 52 T.C.M. (CCH) at 762.

15. I.R.C. § 6501(a) (1987). Generally, the IRS has until three years after the due date of the return to assess the taxpayer when it is unable to prove fraud. *Id.*

16. See, e.g., *Bierschbach v. Commissioner*, 55 T.C.M. (CCH) 790 (1988); *Jordan v. Commissioner*, 52 T.C.M. (CCH) 234 (1986); *Whyte v. Commissioner*, 52 T.C.M. (CCH) 677 (1986).

payer is guilty of fraud is not adequate to carry the burden.¹⁷ In *Mosteller v. Commissioner*, the taxpayer was convicted of bid-rigging in the state courts of Virginia.¹⁸ The IRS presented no proof that the income from the bid-rigging scheme was not reported on his return.¹⁹ Instead, the IRS argued that it is reasonable to infer that a person who will misappropriate another's funds will conceal those funds from the government.²⁰ The court ruled that such an inference is inadequate, standing alone, to prove fraud.²¹ Even if the inference were sufficient to prove that the taxpayer understated his income, it certainly would not prove that the understatement was due to fraud.²² The court noted that, of the two years in which the bid-rigging income should have been reported, one was closed by the statute of limitations.²³ Thus, the tax could not be collected for that year absent a showing of fraud.²⁴

In another recent case, *Nard v. Commissioner*,²⁵ the IRS tried to use the taxpayer's history of nonfiling to prove that he was guilty of fraud in failing to report as income the value of a house constructed for him.²⁶ The statute of limitations had run for a normal deficiency.²⁷ Thus, if the IRS did not succeed in proving the existence of a deficiency based on fraud, the taxpayer could not be assessed.²⁸ The court held that the evidence showed that the taxpayer intended to pay for the house when he received income from a third party.²⁹ Also, the court noted that the taxpayer's history of failure to file was irrelevant to the fraud question.³⁰

The third case in which the IRS did not meet its burden of proving fraud is *Forman v. Commissioner*.³¹ The taxpayer was not employed, but spent an average of 150 days per year at a race track gambling.³² For 1982 he reported net income of \$15,055 from gambling; for 1983 he reported winnings equal to losses.³³ The IRS received reports from the race track con-

17. *Mosteller v. Commissioner*, 52 T.C.M. (CCH) at 763.

18. *Id.* at 759.

19. *Id.* at 761, 764. The taxpayer reported gross receipts in excess of the amount of income from the bid-rigging scheme. *Id.* at 761.

20. *Id.* at 761, 765.

21. *Id.*

22. *Id.*

23. *Id.* at 763.

24. *Id.*

25. *Nard v. Commissioner*, 52 T.C.M. (CCH) 476 (1986).

26. *Id.* at 483.

27. *Id.*

28. *Id.*

29. *Id.* at 484.

30. *Id.* at 483.

31. *Forman v. Commissioner*, 55 T.C.M. (CCH) 139 (1988).

32. *Id.* at 140.

33. *Id.*

cerning all of the taxpayer's winning tickets worth more than \$600.³⁴ The taxpayer had losing tickets to support his claims of losses, but had no additional evidence, such as a daily diary of bets, amounts, horses, and wins or losses.³⁵ The taxpayer's only source of income, besides gambling, was loans from relatives, and he lived quite modestly.³⁶ The court, while ruling that the taxpayer's income was approximately \$10,000 per year higher than he claimed (and \$20,000 per year less than the IRS assessed), disallowed the fraud penalty.³⁷ The taxpayer admitted that he had omitted some winnings from his tax returns, but said that since he had failed to claim some losses, no increase in taxable income resulted.³⁸ The court held that, if unreported income can be offset by unclaimed deductions, the taxpayer is not guilty of fraud.³⁹

IV. FACTORS INDICATING FRAUD

A. *A Pattern of Underpaying Taxes*

There is no one factor that makes the taxpayer liable for the fraud penalty, but there are several factors that the tax court considers, depending on the facts and circumstances of the particular case. In none of the cases examined does the court present a definitive list of these factors, but certain ones are cited by the court in case after case.

One of the more important factors is a pattern of underpaying taxes. None of the cases examined involves an underpayment in only one year for one item (e.g., an underreporting of gross receipts for a certain amount in a single year). But a pattern of underreporting which extends over two to four years, and which usually involves more than one category on the tax return, is likely to result in the successful assessment of the fraud penalty.

There are several cases in which the IRS conducted a very thorough investigation to uncover the truth about the taxpayer's income and deductions over a three- or four-year period. These investigations revealed a pattern of overstated deductions and/or understated income. In *O'Connor v. Commissioner*,⁴⁰ the taxpayer owned a sole proprietorship in the publishing business.⁴¹ The IRS assessed O'Connor approximately \$26,000 for 1976 through 1978, including the fraud penalty.⁴² The taxpayer's returns showed deductions under the categories of wages expense, tax expense, insurance expense, office expense, and miscellaneous expense that were actually per-

34. *Id.*

35. *Id.* at 143.

36. *Id.*

37. *Id.* at 142-43.

38. *Id.*

39. *Id.*

40. *O'Connor v. Commissioner*, 52 T.C.M. (CCH) 499 (1986).

41. *Id.*

42. *Id.*

sonal expenses for such items as travel, private school tuition for the taxpayer's children, home improvements, health and life insurance premiums, federal income tax payments, and the purchase of a savings bond.⁴³ The taxpayer's children worked occasionally in their father's business, but a detailed analysis of their school attendance and other activities revealed that they worked only about 20% of the hours claimed on the taxpayer's tax returns.⁴⁴ The IRS analyzed hundreds of checks, finding over fifty that were for nondeductible items.⁴⁵ Holding that the IRS proved that the taxpayer was guilty of fraud, the court concluded that any of these deductions standing alone could be due to negligence or inadvertence, but the pattern of erroneous deductions indicated fraud.⁴⁶

Another good example of a recent case in which the pattern of the taxpayer's underpayment of his taxes was a key factor in sustaining the imposition of the fraud penalty is *Jordan v. Commissioner*.⁴⁷ The taxpayer, a policeman, owned a multi-unit apartment building.⁴⁸ He reported gross rentals of about \$8,500 per year from 1973 to 1976, but the actual rents received were about \$16,000 per year.⁴⁹ The IRS conducted a very detailed investigation and determined what each tenant paid for each apartment during each year for a four-year period.⁵⁰ The taxpayer also overreported interest expense by an average of \$400 per year and forged charitable contribution receipts totalling \$1,200.⁵¹ The court found the taxpayer guilty of tax fraud, stating that understating income over several years, or substantially overstating deductions, is strong evidence of fraud.⁵²

B. Poor Records and Frequent Cash Transactions

Another factor that indicates fraud is poor records. This includes, in most cases, frequent cash transactions. The tax laws require taxpayers to maintain complete and adequate records.⁵³ One of the cases in which absence of records was crucial to the determination of fraud is *Fisher v. Commissioner*.⁵⁴ The taxpayer, a gambler, kept no record of the bets he made on football games and used cashier's checks payable to fictitious parties to settle the bets.⁵⁵ The IRS used the net worth method to compute his income.⁵⁶

43. *Id.* at 500-02.

44. *Id.* at 501-03, 509-11.

45. *Id.* at 500-06.

46. *Id.* at 512.

47. *Jordan v. Commissioner*, 52 T.C.M. (CCH) 234 (1986).

48. *Id.*

49. *Id.* at 235.

50. *Id.*

51. *Id.* at 236.

52. *Id.* at 238.

53. *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175, 183 (1988) (citing I.R.C. § 6001).

54. *Fisher v. Commissioner*, 55 T.C.M. (CCH) 585 (1988).

55. *Id.* at 586-87.

56. *Id.* at 588-89.

This method adds the increase for the year in the taxpayer's assets to his or her nondeductible living expenses and adjusts for any changes in debts. The resulting increase in net worth is compared to adjusted gross income reported on the year's tax return.⁵⁷ For Fisher the understatement of income exceeded \$100,000 in 1976 and in 1977.⁵⁸ The court held that the net worth method is proper when the taxpayer has inadequate records.⁵⁹ Also, the court found the taxpayer guilty of fraud, citing the absence of records and the use of cashier's checks payable to fictitious parties as attempts to conceal the truth and therefore evidence of fraud.⁶⁰

Another case in which lack of records and use of cash transactions were strong indicators of fraud is *Votsis v. Commissioner*.⁶¹ The taxpayers, two brothers from Greece, operated a restaurant.⁶² They took cash out of the cash register to pay bills and for personal use.⁶³ There was no cash register tape of the day's sales; instead the taxpayers listed an amount that they claimed was the day's sales on a sheet of paper.⁶⁴ The IRS used the net worth method to compute their income.⁶⁵ Finding that their extensive cash dealings and their failure to keep adequate books and records were evidence of fraud, the court found them guilty of civil fraud.⁶⁶

An unusual case involving adequate books and records is *Longstaff v. Commissioner*.⁶⁷ The taxpayer, a psychiatrist, was in private practice and also did consulting work for the state of Indiana.⁶⁸ He failed to report his consulting income on his 1979 and 1980 tax returns; that income exceeded \$90,000 for the two years combined.⁶⁹ Everything else on the returns was correct.⁷⁰ The unusual aspect of this case is that Dr. Longstaff maintained very complete and accurate books and records.⁷¹ Yet, these records provided evidence of his fraudulent intent, according to the court, since a taxpayer with such complete records must have known he had received the omitted income.⁷² Thus, in the proper factual setting, excellent records can indicate

57. *Id.* The IRS need not determine the source of the income when it uses the net worth method. *McLeod v. Commissioner*, 52 T.C.M. (CCH) 254, 260 (1986).

58. *Fisher v. Commissioner*, 55 T.C.M. (CCH) 585, 589 (1988).

59. *Id.* at 592.

60. *Id.* at 595.

61. *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175 (1988).

62. *Id.* at 176.

63. *Id.* at 177, 187.

64. *Id.* at 177.

65. *Id.* at 178-81.

66. *Id.* at 187-88.

67. *Longstaff v. Commissioner*, 55 T.C.M. (CCH) 205 (1988).

68. *Id.* at 205-06.

69. *Id.* at 206.

70. *Id.* at 205-08.

71. *Id.* at 209.

72. *Id.* at 210.

fraud, especially if the amount of underreported income is large and there is other evidence of fraud. The main additional factor in *Longstaff* was that the judge did not find the taxpayer to be a credible witness.⁷³

C. The Taxpayer's Business Ability

A third factor indicative of fraud is the understanding or knowledge that taxes are intentionally understated. In most fraud cases the court raises the issue of the intelligence, training, or experience of the taxpayer. The IRS must show that the taxpayer's understatement of tax was not due to ignorance or inadvertence. In *O'Connor v. Commissioner*,⁷⁴ the taxpayer deducted numerous personal expenses on his business schedule over a four-year period.⁷⁵ The court found that the taxpayer—a highly resourceful and successful businessman—deliberately overstated his deductions in order to evade tax.⁷⁶

There are two cases in which the taxpayers had little formal education. In *Hoak v. Commissioner*,⁷⁷ the taxpayer was illiterate, with the ability to read and write only his name.⁷⁸ He operated a motel, a construction company, and a salvage business; the gross receipts of two of these businesses were understated by an average of over \$100,000 per year for two years.⁷⁹ The court concluded that the taxpayer possessed an unusual ability to operate businesses successfully.⁸⁰ This ability, along with other factors, provided sufficient evidence to convict him of fraud.⁸¹ In *Votsis v. Commissioner*,⁸² the taxpayers were two Greek immigrants who operated a restaurant and underreported gross receipts by a large amount.⁸³ They had no formal education beyond the age of thirteen.⁸⁴ After hearing their testimony, the court concluded that they were astute businessmen.⁸⁵ This fact, along with other factors, provided sufficient evidence to uphold the fraud penalty.⁸⁶

In *Fisher v. Commissioner*,⁸⁷ the taxpayer, a gambler, underreported his income by an average of over \$100,000 per year for two years, according to

73. *Id.* at 211.

74. *O'Connor v. Commissioner*, 53 T.C.M. (CCH) 499 (1986).

75. *Id.* at 500-06.

76. *Id.* at 512.

77. *Hoak v. Commissioner*, 52 T.C.M. (CCH) 123 (1986).

78. *Id.* at 124.

79. *Id.* at 126.

80. *Id.* at 124.

81. *Id.* at 127.

82. *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175 (1988).

83. *Id.* at 176-79.

84. *Id.* at 176.

85. *Id.* at 182.

86. *Id.* at 187-88.

87. *Fisher v. Commissioner*, 55 T.C.M. (CCH) 585 (1988).

the IRS's calculations using the net worth method.⁸⁸ The court, in sustaining the fraud penalty, cited six factors, the first of which was that the taxpayer was a "well-educated, reasonably intelligent, mature individual with considerable experience in business, [who] obviously knew that income from whatever source derived was taxable and that he was required to keep proper records of such income"⁸⁹ Another case in which the court used similar language is *Whyte v. Commissioner*.⁹⁰ The taxpayer owned an engineering consulting corporation.⁹¹ He failed to report dividend income from the corporation that averaged almost \$50,000 per year for the years 1975 through 1978.⁹² He also deducted large amounts of personal expenses as various categories of business expenses.⁹³ The court concluded: "Petitioner's business success, his understanding of his business, as exhibited at trial, and his review of the returns in issue, convince us that he was substantially better informed on these matters than he wished us to believe."⁹⁴ This was one of three points the court made in explaining its decision to sustain the IRS's additions to tax for fraud.⁹⁵

The last case concerning the taxpayer's knowledge and ability, *Longstaff v. Commissioner*,⁹⁶ involved taxpayers who had severe illnesses. The taxpayer, a psychiatrist, failed to report consulting income averaging \$45,000 per year for two years.⁹⁷ The court found that the taxpayer and his wife possessed "sufficient education, experience, and tax sophistication to understand the obligation to report all income received"⁹⁸ However, the taxpayers claimed that they were incapable of forming the specific intent necessary for fraud because of their illnesses.⁹⁹ Mrs. Longstaff had cancer surgery and was fatigued, and also had painful episodes of sciatica during the tax years in question.¹⁰⁰ Dr. Longstaff, a paraplegic due to polio, had heart bypass surgery, and complications resulted due to his paraplegia.¹⁰¹ The court responded by noting that the taxpayers didn't undergo psychiatric care; there was no evidence of mental illness in either of them; and they engaged in their normal work and investment activities during this period.¹⁰² Consequently, the court found them guilty of fraud, concluding that the

88. *Id.* at 588-89.

89. *Id.* at 595.

90. *Whyte v. Commissioner*, 52 T.C.M. (CCH) 677 (1986).

91. *Id.* at 679.

92. *Id.* at 679-80.

93. *Id.* at 689.

94. *Id.* at 689-90.

95. *Id.*

96. *Longstaff v. Commissioner*, 55 T.C.M. (CCH) 205 (1988).

97. *Id.* at 206.

98. *Id.* at 210.

99. *Id.* at 211.

100. *Id.* at 207.

101. *Id.*

102. *Id.* at 211.

claim that they could not form a fraudulent intent "can be likened to the proverbial old hound dog that just [wouldn't] hunt."¹⁰³

D. The Taxpayer's Failure to Cooperate

Another important factor indicating fraud is the taxpayer's failure to cooperate with the IRS investigation of his or her tax returns. Such a taxpayer response suggests that the taxpayer is trying to hide the truth, thus, manifesting a fraudulent intent. The most extreme form of uncooperativeness is failure to respond to the IRS allegations supporting the fraud penalty. A court will uphold the penalty in this instance, reasoning that the allegations are deemed to be admitted by the taxpayer's failure to respond, and thus the IRS has satisfied its burden of proving fraud.¹⁰⁴ The taxpayer can also be uncooperative by lying or by presenting unreasonable excuses for underpayment. Since the taxpayer usually testifies in court in tax cases involving the fraud penalty, the court has an opportunity to decide if the taxpayer is being cooperative and truthful.

Failure to cooperate was an important factor in sustaining the fraud penalty in *Jordan v. Commissioner*.¹⁰⁵ The taxpayer had understated rental income and overstated certain deductions by a large amount for four years.¹⁰⁶ The court, holding that failure to cooperate indicates fraud, found that the taxpayer failed to produce certain records, lied several times to IRS agents, and produced altered or forged documents in an effort to mislead them.¹⁰⁷ The taxpayers in *Votsis v. Commissioner*¹⁰⁸ also failed to cooperate, in a manner similar to the taxpayer's behavior in *Jordan*.¹⁰⁹ In *Votsis*, the taxpayers' income was reconstructed by the IRS according to the net worth method.¹¹⁰ One of the four factors cited by the court in upholding the fraud penalty was the fact that the taxpayers lied to the IRS and to the court.¹¹¹ The court discussed misleading omissions and oral testimony which contradicted written evidence in its characterization of false statements made by

103. *Id.*

104. See, e.g., *Siravo v. Commissioner*, 52 T.C.M. (CCH) 663 (1986); *Alter v. Commissioner*, 52 T.C.M. (CCH) 628 (1986); *Ricotta v. Commissioner*, 52 T.C.M. (CCH) 774 (1986).

105. *Jordan v. Commissioner*, 52 T.C.M. (CCH) 234 (1986).

106. *Id.* at 234-37.

107. *Id.* at 238.

108. *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175 (1988).

109. *Id.* at 188.

110. *Id.* at 178-82.

111. *Id.* at 188. Another important case in which the court did not believe the taxpayer is *McLeod v. Commissioner*, 52 T.C.M. (CCH) 254 (1986). After an extensive investigation of the taxpayer's lifestyle, the IRS, using the net worth method, increased the taxpayer's income by an average of \$40,000 per year for four years. *Id.* at 256-58. The taxpayer claimed he had saved \$68,000 over the previous eighteen years and that he did not pay for numerous expensive gifts to his family as the IRS contended. The court found this testimony to be inconsistent and incredible. *Id.* at 259.

the taxpayers.¹¹² Like any trier of fact, the tax court need not believe the testimony of the taxpayer, but in a tax fraud case the fact that the taxpayer makes false statements is itself evidence of fraud.¹¹³ Like the other factors, however, lying does not, by itself, prove fraud. Also, false statements must be distinguished from flawed testimony. The tax court cautioned that "mere suspicion does not prove fraud, and the fact that we do not find the taxpayer's testimony wholly credible is not sufficient to establish fraud."¹¹⁴

The taxpayer's uncooperative behavior can take another form—an attempt to blame his tax underpayment on his accountant. The court is not sympathetic to such a claim. In *O'Connor v. Commissioner*,¹¹⁵ the taxpayer deducted numerous personal expenses as business expenses over a three-year period.¹¹⁶ He testified that it was the preparer's fault, claiming that he gave the preparer all of his disorganized and uncategorized checks in a paper bag.¹¹⁷ Thus, the taxpayer claimed that the preparer judged whether each check was deductible, and, if so, under what category.¹¹⁸ The court believed the testimony of the H & R Block manager, who testified that the fee charged for preparing the taxpayer's return (about \$75 per year) was so low that the taxpayer must have arranged the checks by category and amount.¹¹⁹ Also, an IRS agent testified that the taxpayer's handwriting showed the category for each group of checks, and all of the errors on the taxpayer's returns were in his favor, an unlikely result if the preparer were responsible for determining and categorizing the deductions.¹²⁰ The court, satisfied that the taxpayer's argument blaming his preparer had been refuted, upheld the fraud penalty.¹²¹

In *Whyte v. Commissioner*,¹²² the taxpayer also blamed the preparer for the underpayment of taxes.¹²³ The taxpayer, who owned an engineering consulting corporation, failed to report some corporate income and deducted some personal expenses from 1975 to 1978.¹²⁴ In addition, on his individual return he underreported dividend income from his corporation to the extent of almost \$50,000 per year for the same four-year period.¹²⁵ In sustaining the IRS's assessment of the fraud penalty, the court pointed to three factors

112. *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175, 188 (1988).

113. *Foundation Steel Et Wire v. Commissioner*, 52 T.C.M. (CCH) 442, 447 (1986).

114. *Mosteller v. Commissioner*, 52 T.C.M. (CCH) 758, 763 (1986).

115. *O'Connor v. Commissioner*, 52 T.C.M. (CCH) 499 (1986).

116. *Id.* at 499-506.

117. *Id.* at 512-13.

118. *Id.* at 513.

119. *Id.*

120. *Id.*

121. *Id.* at 513-14.

122. *Whyte v. Commissioner*, 52 T.C.M. (CCH) 677 (1986).

123. *Id.* at 689.

124. *Id.* at 679.

125. *Id.* at 679-80.

that indicated fraud.¹²⁶ The first was cited in response to the taxpayer's claim that he relied on his accountant to prepare his tax returns, and therefore he (the taxpayer) could not be guilty of fraud.¹²⁷ The court replied that the taxpayer did not provide the accountant with the information necessary to prepare the returns.¹²⁸ Instead, he concealed income from the preparer, on both his individual and his corporate returns, and gave the preparer a list of expenses that categorized personal expenses as repair, seminar, or consulting expenses.¹²⁹ In one other case in which the taxpayer blamed the accountant for the mistakes in the tax return, the accountant had died during the time in question.¹³⁰ The taxpayers argued that this should absolve them from the fraud penalty.¹³¹ The court, however, found that the taxpayers had concealed income from the accountant and therefore were liable for fraud.¹³²

E. Conviction Under Criminal Tax Statutes

A final factor indicating fraud is the taxpayer's guilt under criminal tax statutes. There are two relevant statutes, section 7201 and section 7206(1) of the Internal Revenue Code.¹³³ Section 7201 makes it a felony willfully to attempt to evade or defeat any tax. Section 7206(1) makes it a felony knowingly to file a false tax return. If the taxpayer has been found guilty (or pled guilty) to violating 7201, he or she is estopped from denying liability for violating the section 6653(b) civil tax fraud statute for the years involved in the section 7201 conviction.¹³⁴ However, usually the IRS assesses the fraud penalty for more years than those involved in the taxpayer's conviction under section 7201.¹³⁵ Therefore, the IRS must prove fraud for the years not involved in the conviction.

A guilty plea or conviction under section 7206(1) is not equivalent to an admission of guilt under section 6653(b).¹³⁶ Instead, a conviction under 7206(1) is merely an additional factor indicating fraud.¹³⁷ This is because intent to evade tax is not an element of 7206(1) and such an intent is an element of 6653(b).¹³⁸

126. *Id.* at 689-90.

127. *Id.* at 689.

128. *Id.*

129. *Id.*

130. *Longstaff v. Commissioner*, 55 T.C.M. (CCH) 205, 208 (1988).

131. *Id.* at 211.

132. *Id.*

133. I.R.C. §§ 7201, 7206(1) (1988).

134. *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175, 187 (1988).

135. See, e.g., *Votsis v. Commissioner*, 55 T.C.M. (CCH) 175 (1988); *Hoak v. Commissioner*, 52 T.C.M. (CCH) 123 (1986).

136. *Jordan v. Commissioner*, 52 T.C.M. (CCH) 235, 238 (1986).

137. *Id.*

138. *Id.*

V. CONCLUSION

The above cases lead to the conclusion that a taxpayer who does the following is most likely to be held liable for the fraud penalty:

- (1) Misstates a variety of items on his or her tax returns for more than one year where the amount of underpayment is substantial;
- (2) Keeps poor records and engages in frequent cash transactions;
- (3) Has sufficient ability to understand that he or she is deliberately evading taxes;
- (4) Fails to cooperate with the IRS investigation; or
- (5) Has been convicted under certain criminal tax statutes.

Of course, not all of the above need to be present to result in a conviction. The facts and circumstances of each case determine the mix of factors that will allow the IRS to successfully assess the fraud penalty.