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Federal Income Taxes and the Civil Fraud Penalty

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COMMENT

FEDERAL INCOME TAXES AND THE CIVIL FRAUD PENALTY

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The drive against tax evaders is now in full swing after a complete reorganization of the Internal Revenue Service, and the new Commissioner has promised an efficient enforcement of all revenue laws. Although the effective administration of the federal income tax rests primarily upon the willingness of the taxpayer voluntarily to disclose his correct income, Congress has provided certain civil[1] and criminal[2] penalties to punish those who have not fulfilled their obligations to the United States Treasury. This article will deal only with the administration and operation of the civil fraud penalty.

The most severe civil penalty that may be inflicted, the 50 per cent fraud penalty,[3] is actually not regarded by the courts as a penalty at all, but has been described merely as a compensatory sum to reimburse the Government for its added expense in detecting the violation.[4] Although the reasoning behind this result is not entirely convincing, it has served as the basis for imposing the fraud penalty against the estate of a taxpayer after his death.[5]

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1. Although there are several other comparatively minor civil penalties, the only one under consideration here is the 50 per cent fraud penalty which provides: "If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2)." INT. REV. CODE § 293(b).

2. There are also several miscellaneous criminal provisions in the Internal Revenue Code. The most widely used provision provides: "Any person required under this chapter to collect, account for, and pay over any tax imposed by this chapter, who willfully fails to collect or truthfully account for and pay over such tax, and any person who willfully attempts in any manner to evade or defeat any tax imposed by this chapter or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution." INT. REV. CODE § 145(b).

3. See note 1 *supra*.

4. Helvering v. Mitchell, 303 U.S. 391, 58 Sup. Ct. 630, 82 L. Ed. 917 (1938); Reimer's Estate v. Commissioner, 180 F.2d 159 (6th Cir. 1950); Estate of Joseph Nitto, 13 T.C. 858 (1949).

5. Kirk v. Commissioner, 179 F.2d 619 (1st Cir. 1950). In this case the taxpayer conceded filing a fraudulent return; a deficiency was assessed against him and the 50 per cent fraud penalty was added. Prior to assessment of the penalty the taxpayer died. In determining whether the 50 per cent penalty survived his death the court decided that it was only necessary to determine whether the fraud penalty was remedial or penal. The first circuit court relied on the *Mitchell* case, *supra* note 4, and held that it was remedial and thus survived against the taxpayer's estate.

It will be noted from an examination of the language of Section 293(b) that the fraud penalty is asserted against the total amount of the deficiency[6] if any part thereof is due to fraud. There are thus two essential elements: (1) the existence of a deficiency and (2) the finding that a part of the deficiency is due to fraud with intent to evade tax.

Statute of Limitations

In general, the period of limitations upon the assessment of a tax is three years from the date the return is filed[7] unless the period of limitations has been extended by agreement.[8] If fraud exists, however, there is no period of limitations, and an assessment may be made at any time.[9] It thus results that a civil suit for the amount of tax due plus the fraud penalty almost always follows the criminal prosecution where both are recommended, since the latter has a six year period of limitations.[10]

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6. The word "deficiency" is a technical term which is defined as follows: "As used in this chapter in respect of a tax imposed by this chapter, 'deficiency' means the amount by which the tax imposed by this chapter exceeds the excess of — (1) the sum of (A) the amount shown as the tax by the taxpayer upon return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over — (2) the amount of rebates, as defined in subsection (b)(2), made." INT. REV. CODE § 271(a).

7. "Except as provided in section 276 — (a) General Rule. The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period." INT. REV. CODE § 275. However, if a return is filed before March 15th, for purposes of determining the period of limitations, it is treated as having been filed on March 15th. INT. REV. CODE § 272(f).

8. Section 276(b) provides for a waiver of the period of limitations upon the written consent of the Commissioner and the taxpayer. If the Commissioner desires an extension of time, he will ask the taxpayer to sign the Government's Form 872. This often leaves the taxpayer with the alternative of giving the Commissioner extra time to investigate his return or else having an immediate assessment made against him which will more than likely be inaccurate and greatly excessive.

Section 277 provides for a suspension of the running of the statute of limitations after the mailing of a 90 day letter for the 90 day period during which the Commissioner is prohibited from making an assessment and for sixty days thereafter.

9. "In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time." INT. REV. CODE § 276(a).

10. "(a) Criminal prosecutions. No person shall be prosecuted, tried, or punished, for any of the various offenses arising under the internal revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense, except that the period of limitation shall be six years — (2) for the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof. . . ." INT. REV. CODE § 3748. And if the taxpayer is found guilty of criminal fraud, the civil fraud penalty follows almost as a matter of course and is easily sustained since the burden of proof in civil cases is less than that in criminal cases. See note 27 *infra*.

Burden of Proof

In all cases where the fraud penalty is asserted the burden of proof with respect to the issue of fraud is on the Commissioner.[11] This is an affirmative burden and is often a difficult one to sustain since it is well-recognized that fraud cannot be lightly inferred, but must be established by clear and convincing evidence.[12] However, if the taxpayer defaults as to the issue of fraud or is absent from the hearing as is oftentimes the case, only a slight amount of proof would seem to be necessary to persuade the Tax Court to sustain the fraud penalty.[13]

The degree of proof required on the issue of fraud in a civil case is that it be clear and convincing whereas in a criminal case it must be beyond a reasonable doubt.[14] It thus results that a person may be indicted for criminal fraud, tried and acquitted and still be found guilty of civil fraud in a later trial. That question was decided by the Supreme Court in the case of *Helvering v. Mitchell*,[15] which held that the difference in degree of the burden of proof in criminal and civil cases precluded application of the doctrine of *res judicata* and that in the civil enforcement of a remedial section there can be no double jeopardy. Since this decision there has been no question as to the right to assert both criminal and civil fraud penalties against a taxpayer.

The burden of proof as to the amount of the deficiency is always on the taxpayer since there is a presumption that the Commissioner's

11. INT. REV. CODE § 1112. This section was enacted specifically to govern the Tax Court, but the same rule has been applied by the federal courts. *E.g.*, Davis v. Commissioner, 184 F.2d 86 (10th Cir. 1950); Rogers v. Commissioner, 111 F.2d 987 (6th Cir. 1940); Duffin v. Lucas, 55 F.2d 786 (6th Cir. 1932); Jemison v. Commissioner, 45 F.2d 4 (5th Cir. 1930).

If the fraud penalty is assessed for open years the taxpayer will have the burden as to the deficiency and the Commissioner will have the burden as to the issue of fraud. In a closed year, however, the Commissioner must prove the existence of fraud or else be precluded by the statute of limitations from collecting any of the tax.

12. Davis v. Commissioner, 184 F.2d 86 (10th Cir. 1950); Rogers v. Commissioner, 111 F.2d 987 (6th Cir. 1940); M. Rae Gano, 19 B.T.A. 518, 532 (1930); 2 RABKIN AND JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 75.04 (1951).

13. BALTER, FRAUD UNDER FEDERAL TAX LAW 166 (2d ed. 1953); Nathan Galvin, 11 TCM 865 (1952); Thomas Campisi, 10 TCM 1151 (1952).

14. *E.g.*, Banks v. United States, 204 F.2d 666 (8th Cir. 1953); Gendelman v. United States, 191 F.2d 993 (9th Cir. 1951); United States v. Fenwick, 177 F.2d 488 (7th Cir. 1949).

15. 303 U.S. 391, 58 Sup. Ct. 630, 82 L. Ed. 917 (1938). In the *Mitchell* case the defendant had been indicted for tax fraud and acquitted but had later been found guilty of civil fraud by the Board of Tax Appeals as to one of the same items on which he had previously been acquitted in the criminal action. On appeal the circuit court reversed the Board in part in that it allowed the assessment of the deficiency, but it denied the imposition of the fraud penalty because of the prior acquittal in the criminal action. Certiorari was granted and in the Supreme Court defendant contended that the fraud penalty was barred by the doctrines of *res judicata* and double jeopardy. *Accord*, Hoefle v. Commissioner, 114 F.2d 713 (6th Cir. 1940); Mauch v. Commissioner, 113 F.2d 555 (3d Cir. 1940).

determination is correct.[16] This presumption requires the taxpayer to come forward at the start of the case with some positive evidence that the deficiency is incorrect. It is only a rule of procedure, however, and once some relevant evidence is introduced by the taxpayer which indicates that the Commissioner's determination is incorrect, the burden of introducing rebuttal evidence shifts to the Commissioner.[17] The taxpayer's burden of overcoming the deficiency is also a difficult one and his failure to present sufficient proof to overcome the presumption often results in the deficiency being sustained.[18] There is no definite standard as to the amount of proof necessary to overcome a deficiency, but the Supreme Court has held in the leading case of *Helvering v. Taylor*[19] that a showing by the taxpayer that the Commissioner's determination is arbitrary and excessive will be sufficient. He need not also show the exact amount of tax actually due.

Effect of Amended and Delinquent Returns

It is now well-settled that the filing of an amended return does not prevent the imposition of the fraud penalty.[20] Taxpayers have sought unsuccessfully in several instances, however, to establish that after an amended return is filed there is no deficiency to which the fraud penalty may be applied. The Treasury Regulations have for many years contained the statement now appearing in Regulations 118, Section 39.271-1, that the additional tax shown on an amended return is a deficiency within the meaning of the Internal Revenue Code. The Tax Court has upheld this view in several decisions the most notable of which are *Aaron Hirschman*[21] and *Maitland A. Wilson*.[22]

It is believed, however, that a different result will follow in the case of a delinquent return. If an original return has never been filed, but a delinquent return is later filed, the delinquent return is treated as "the return" for purposes of determining the existence of a deficiency. Thus, if a correct delinquent return is filed before the assess-

16. "The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent." Rules of Practice, Tax Court, Rule 32. See Welch v. Helvering, 290 U.S. 111, 54 Sup. Ct. 8, 78 L. Ed. 212 (1933); Rogers v. Commissioner, 111 F.2d 987 (6th Cir. 1940); Avery v. Commissioner, 22 F.2d 6 (5th Cir. 1927); 2 RABKIN AND JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 72.03 (1951).

17. Hemphill Schools v. Commissioner, 137 F.2d 961 (9th Cir. 1943); J. M. Perry & Co. v. Commissioner, 120 F.2d 123 (9th Cir. 1941); 2 RABKIN AND JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 72.03 (1951).

18. Copelon, *Practical Problems on Burden of Proof in Civil Trials*, N.Y.U. TENTH ANNUAL INSTITUTE ON TAXATION 865 (1951).

19. 293 U.S. 507, 55 Sup. Ct. 287, 79 L. Ed. 623 (1935).

20. George M. Still, Inc., 19 T.C. 1072 (1953); Henry T. Harmel, 11 TCM 599 (1952); Hyman Wagman, 10 TCM 836 (1951); Michael Samuel's Estate, 9 TCM 196 (1950), *aff'd*, 189 F.2d 857 (2d Cir. 1951); Aaron Hirschman, 12 T.C. 1223 (1949); Maitland A. Wilson, 7 T.C. 395 (1946).

21. 12 T.C. 1223 (1949).

22. 7 T.C. 395 (1946).

ment of a deficiency there will be no deficiency to which the fraud penalty can attach.[23]

Failure to File Returns

Fraud penalties may be asserted in cases where the taxpayer has failed to file a return,[24] and all that the Commissioner has to show to sustain the penalty is that there was taxable income in excess of $600 and that the taxpayer knew of the obligation to file a return.

Cases sustaining the fraud penalty where no return is filed have done so on the theory that by failing to file a return the taxpayer has created a deficiency equal to the total amount of the tax due on the unreported income. If the taxpayer knew that he had taxable income in excess of $600 and willfully failed to file a return then the "deficiency is due to fraud with intent to evade tax" and the 50 per cent fraud penalty would be applicable.[25]

If no return is filed, not only may the taxpayer be confronted with the fraud penalty, but the 25 per cent penalty for failure to file a return will also be imposed.[26] In a recent eighth circuit decision, *First Trust & Savings Bank of Davenport v. United States*,[27] however, where no returns were filed, the court reversed the Tax Court's findings of fraud and imposed only the 25 per cent penalty for failure to file a return. The taxpayer failed to file returns for eight years. The fraud penalty was assessed and paid and a suit for refund was brought. At the time of the trial the taxpayer was 71 years of age and he testified that no one had ever told him that he had to file a return and that he thought that he was not making any income. He had previously been informed against criminally under Section 145(a) for willfully failing to file a return for 1945 and entered a plea of guilty and paid a fine of $10,000. It would appear that his plea of guilty to the charge of willfully failing to file a return would be a sufficient admission to establish by clear and convincing evidence that the deficiency was due to fraud with intent to evade tax, thus allowing the imposition of the fraud penalty.[28] The court, however, by relying on the *Spies*[29] case which distinguished the acts that would constitute a misdemeanor under Section 145(a) and a felony under Section 145(b), held that the taxpayer was only subject to the 25 per cent penalty under Section

23. The taxpayer would be liable, however, for the 25 per cent penalty for failure to file a return on time. INT. REV. CODE § 291(a).

24. Edward M. Jackson, 12 TCM 778 (1953); David E. Ringler, 11 TCM 772 (1952); Henry H. Epstein, 34 B.T.A. 925 (1936); Pincus Brecher, 27 B.T.A. 1108 (1933).

25. 4 CCH FED. TAX REP. ¶ 1515.01 (1954).

26. INT. REV. CODE § 291(a); Joseph V. Moriarity, 18 T.C. 327 (1952); Robert G. Tyson, 9 TCM 162 (1950); Frank Hendrick, 7 TCM 364 (1948).

27. 206 F.2d 97 (8th Cir. 1953).

28. Kenney v. Commissioner, 111 F.2d 374 (1940); Frank P. Mineo, 10 TCM 1101 (1952); Leo E. Lufkin, 10 TCM 196 (1951).

29. 317 U.S. 492, 63 Sup. Ct. 364, 87 L. Ed. 418 (1943).

291 for failure to file a return since his failure to file was a "wilful omission" rather than an "affirmative commission." The court reasoned that since Congress had provided different penalties for failing to file a return and for a deficiency due to fraud, that the fraud penalty should be asserted only where there existed some affirmative acts of fraud. Although there is no clear cut definition of what constitutes fraud, it seems that a holding that the Tax Court's finding of fraud was clearly erroneous was not justified under the facts of this case.

Omitted Income

The majority of cases in which the fraud penalty is asserted are situations where the taxpayer has knowingly and purposely omitted taxable income from his returns. Although taxpayers have devised a number of ingenious schemes to conceal income,[30] it is believed that there is no such thing as a foolproof scheme for evading taxes and that the diligence and ingenuity of the special agents make detection only a matter of time and effort. In the case of *M. Rae Gano*,[31] one of the earliest fraud cases decided before the Board of Tax Appeals, unreported income had been found for several years. In approving fraud penalties the court stated: "A failure to report for taxation income unquestionably received, such action being predicated on a patently lame and untenable excuse would seem to permit of no difference of opinion. It evidences a fraudulent purpose."[32]

It should be emphasized, however, that in order for fraud to exist the taxpayer must know that his return was false. It is not sufficient that he should have known or that he might have known that the return was false. Thus, in *Mitchell v. Commissioner*,[33] in which the Fifth Circuit Court reversed the Tax Court's finding of fraud it was held that gross negligence or carelessness or indifference was not the type of action that would sustain a fraud penalty. On the contrary the court, citing *Griffiths v. Commissioner*,[34] stated: "Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. Mere negligence does not establish either."[35] This burden of showing a "specific purpose to evade" is the Government's most difficult task and often the taxpayer's greatest hope.

30. Goldberg v. Commissioner, 100 F.2d 601 (7th Cir. 1938) (fictitious sale of assets was made to take tax advantages); Sam D. Hecht, 16 T.C. 981 (1951) (dummies were used to report taxpayer's income); William W. Kellett, 5 T.C. 608 (1945) (an employee failed to report "gifts" of cash and stock bonuses from his employer); Harry F. Canelo, 41 B.T.A. 713 (1940) (the taxpayer reported part of his own income as the income of a nonexistent trust).
31. 19 B.T.A. 518 (1930).
32. 19 B.T.A. 518, 533 (1930).
33. 118 F.2d 308 (5th Cir. 1941).
34. 50 F.2d 782 (7th Cir. 1931).
35. 118 F.2d 308, 310 (5th Cir. 1941).

Besides those cases in which there was a failure to file a return and in which income was purposely omitted there are a number of miscellaneous situations in which the fraud penalty has been asserted. For example in the case of *Joseph H. Imeson*,[36] the taxpayer, a T.W.A. pilot, had claimed business deductions and traveling expenses amounting to $5,624. Most of the traveling expenses were estimated and were disallowed because they could not be substantiated. The crucial item, however, was a deduction of $797.10 for pleasure and unexplained personal trips. It was largely on this item that the Government made its determination of fraud. The taxpayer's defense was that his return had been prepared by an experienced and competent tax man who had assured him that all of his traveling expenses were allowable deductions even though personal and for pleasure.[37] The Tax Court in sustaining the fraud penalty stated that it was not likely that a person of the taxpayer's position and experience would believe that amounts expended for travel for personal pleasure were proper deductions.

Conclusion

One representing a taxpayer whose returns are under investigation should do everything possible to prevent the imposition of the fraud penalty. This can only be done, if there are indications of fraud, by having a conference with the investigating revenue agent and convincing him by competent proof that any deficiency that exists is due to some factor other than fraud on the part of the taxpayer. Such a conference should be requested as early in the investigation as possible if the taxpayer's position can be sustained.

As to the imposition of the fraud penalty, there is no excuse for its assertion against a taxpayer who has not misrepresented the facts in his return or where some real doubt exists among tax experts that a deficiency can be sustained as a matter of law. The penalty was asserted, however, in a recent well-known case which required a Supreme Court decision to settle the basic question of civil liability.[38] It is believed, however, that the penalty will rarely be asserted and never sustained where the taxpayer accurately discloses in his return all the facts which he in good faith believes to be material.

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36. 14 T.C. 1151 (1950).

37. Ordinarily, reliance upon a competent individual is a valid defense to a charge of fraud if all the facts are disclosed to that individual. Davis v. Commissioner, 184 F.2d 86 (10th Cir. 1950). The *Imeson* case establishes an exception to the above rule where all of the facts are not revealed or where the person relied upon has a questionable reputation. The advisor in the *Imeson* case had previously been disbarred from the practice of law and had been convicted and sentenced for larceny and embezzlement.

38. Commissioner v. Court Holding Co., 324 U.S. 331, 65 Sup. Ct. 707, 89 L. Ed. 981 (1945).