

Civil Tax Fraud: Should 75 Percent Appear Too Small, Be Thankful the IRS Doesn't Take It All

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Mistakes happen, including when it comes to reporting and paying taxes. And for taxpayers and their advisors, those mistakes can lead to costly consequences, as the Internal Revenue Code (“Code”) ¹ allows the Internal Revenue Service (“IRS”) to impose penalties (and other punitive measures) for errors, including those that result in a substantial understatement of tax.² The same can be said for errors based on negligence, which the IRS can penalize even if the errors resulted in tax understatements that are not substantial.³ However, when errors result from fraudulent conduct, the Code reserves some of its harshest consequences.

This article is the first in a series about civil tax fraud, in which we will explore where civil fraud falls in the tax administration and enforcement scheme. This article outlines the basic elements that the IRS must prove to establish that a taxpayer engaged in fraudulent conduct, explains how civil tax fraud differs from criminal tax fraud, compares sanctions under the Code for understatements of tax attributable to negligence to those understatements attributable to fraud, and discusses the consequences—which extend beyond penalties—that taxpayers could face if they are subject to a civil fraud determination.

What Is Civil Tax Fraud?

The first consequence that typically comes to tax practitioners’ minds with respect to the concept of civil fraud is the Code’s fraud penalty, which is found under Code Sec. 6663(a). Under that provision, “[i]f any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.” The 75-percent penalty is one of the harshest civil penalties that the IRS can impose on taxpayers.

So what, exactly, is fraud, and what must the government establish before imposing a fraud penalty? In *Edelson*, the Ninth Circuit interpreted fraud for

purposes of Code Sec. 6663 as “intentional wrongdoing on the part of the taxpayer with the specific purpose of evading a tax believed to be owing,”⁴ a definition that other courts have adopted.⁵ If the IRS seeks to prove that a taxpayer’s conduct is fraudulent, the IRS has the burden of proving its case by clear and convincing evidence.⁶ If the IRS asserts that fraudulent activity occurred in multiple years, the IRS must prove that the taxpayer engaged in fraudulent conduct in each year for which the penalty is asserted.⁷ Under the mandates of Code Sec. 6663(b), if the IRS “establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be attributable to fraud” unless the taxpayer proves, by a preponderance of evidence, that a portion of the tax underpayment is not connected to fraudulent conduct.

Moreover, Code Sec. 6663(c) provides that “[i]n the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse,” meaning that the IRS must prove by clear and convincing evidence that, when there is a joint return, both spouses had fraudulent intent in order to impose penalties on both spouses.

While the penalty for civil tax fraud is steep, worse still is a finding that a taxpayer’s fraudulent behavior rises to the level of a criminal offense.

In asserting a civil fraud penalty, the IRS bears the burden of proving that “the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead or otherwise prevent the collection of taxes.”⁸ Moreover, while it may seem somewhat self-evident, the IRS must, as an initial matter, prove that the taxpayer actually underpaid his or her taxes.⁹ Indeed, without an underpayment, there is nothing by which to apply a 75-percent penalty.¹⁰ If the IRS can prove that an underpayment occurred, it must then also prove by clear and convincing evidence that the return was filed with fraudulent intent.¹¹

As one might imagine, direct evidence of a taxpayer’s intent to conceal, mislead, or prevent the collection of taxes may be difficult to come by. As a result, the IRS frequently relies on circumstantial evidence to establish a taxpayer’s fraudulent intent.¹² Courts often turn to several

factors, commonly referred to as “badges of fraud,” to guide their inquiry into whether a taxpayer had the requisite scienter for the imposition of a penalty for civil tax fraud.¹³ The “badges” include:

- (1) [u]nderstating income, (2) maintaining inadequate records, (3) implausible or inconsistent explanations of behavior, (4) concealment of income or assets, (5) failing to cooperate with tax authorities, (6) engaging in illegal activities, (7) an intent to mislead which may be inferred from a pattern of conduct, (8) lack of credibility of the taxpayer’s testimony, (9) filing false documents, (10) failing to file tax returns, and (11) dealing in cash.¹⁴

These indicia of fraud are nonexclusive, and, certainly, the existence of one (or even several) of these badges does not automatically equate to a fraud determination.¹⁵ Whether or not fraud exists is examined based on the totality of the circumstances.

Even when evidence of these badges exists, accused taxpayers may negate a finding of fraud by asserting a defense, stemming from the seminal Supreme Court case *Cheek*,¹⁶ that they had a good-faith misunderstanding of the law and that their conduct was not intentional or willful. It is important for taxpayers to understand, however, that there is a difference between a misunderstanding (or incorrect interpretation) of one’s legal obligations and a disagreement with the tax laws. A disagreement with the tax laws does not negate fraudulent intent.

Moreover, a taxpayer facing liability for a fraud penalty under Code Sec. 6663 is permitted to invoke a “reasonable cause” defense as outlined in Code Sec. 6664(c); however, given that a fraud finding requires an intent to avoid the reporting, assessment, or payment of tax liability, as described above, reasonable cause defenses are often difficult to mount in the civil fraud context.

How Does Civil Tax Fraud Compare to Criminal Tax Fraud?

While the penalty for civil tax fraud is steep, worse still is a finding that a taxpayer’s fraudulent behavior rises to the level of a criminal offense. A number of criminal statutes penalize fraudulent conduct related to federal taxes, including Code Secs. 7201–7207. The broadest of these offenses, and the one that carries the highest potential penalty, is an “attempt to evade or defeat tax” found under Code Sec. 7201, which states that

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

Of note, Code Sec. 7201 specifically leaves the door open to “other penalties provided by law,” which would include the civil fraud penalty.

So, what is the difference between civil tax fraud and tax fraud that rises to the level of criminality? These two offenses are not so dissimilar—in fact, they involve the same or similar markers. Compare the definition of fraud in *Edelson*—“intentional wrongdoing ... with the specific purpose of evading a tax believed to be owing”—with Code Sec. 7201—“willfully attempt[] in any manner to evade or defeat a tax.” The two read very similarly. Where civil and criminal tax frauds most differ is the government’s burden of proof in establishing liability. As noted above, in the civil context, the government must establish by “clear and convincing” evidence that a taxpayer engaged in fraudulent conduct. In the criminal context, however, the standard is significantly higher, and fraudulent conduct and intent must be proved “beyond a reasonable doubt.” So, often the dividing line between the assertion of a civil fraud penalty and a criminal prosecution is the government’s confidence in its ability to persuade a jury. Criminal investigations and prosecutions are extremely resource- and time-intensive, so the government tends to reserve criminal charges for the worst offenders or cases where it believes it is most likely to obtain a guilty verdict.

How Does Civil Tax Fraud Compare to Negligence, Recklessness, or Omissions?

The Code provides for several lesser accuracy-related penalties for underpayments of taxes due to errors stemming from taxpayer conduct that do not approach fraud’s willfulness or intentional standards. Under Code Sec. 6662, the Code categorizes tax underpayment attributable to (1) negligence and (2) the careless, reckless, or intentional disregard of rules or regulations within the context of “accuracy-related” errors, making a determination to impose penalties based on those of mental states mutually exclusive from a finding of civil tax fraud.

Specifically, Code Sec. 6662(b)(1) provides for a 20-percent penalty for underpayments of tax attributable to “[n]egligence or disregard of rules or regulations.” “Negligence” is defined in Code Sec. 6662(c) to include “any failure to make a reasonable attempt to comply with the provisions of” the Code, and “disregard” is defined to “include[] any careless, reckless, or intentional disregard.” Courts have rounded out these definitions, holding that negligence for underpayments of tax is defined as “lack of due care or the failure to do what a reasonable and prudent person would do under similar circumstances.”¹⁷

Practitioners should understand the risks associated with a finding of civil tax fraud, including the potential for dual-tracked proceedings of civil and criminal tax fraud, and the collateral consequences of a fraud determination.

As such, the real difference between civil tax fraud, on the one hand, and negligence and reckless disregard of tax rules or regulations, on the other, is the level of willfulness or intent tied to the sanctionable conduct. That is, fraud depends on a finding, proven by clear and convincing evidence, that the taxpayer knew or believed that they owed a tax and acted with the intent to avoid such tax. Negligence, and a reckless disregard of rules or regulations, can be established pursuant to lower evidentiary thresholds and proof of a lesser mental culpability. These differences are reflected in the disparate penal consequences for negligent and fraudulent conduct, with accuracy-related underpayments under Code Sec. 6662(b)(1) subject to a 20-percent penalty and fraud-related underpayments under Code Sec. 6663(a) subject to a 75-percent penalty.

What Are the Consequences of a Civil Tax Fraud Determination?

Not only can a civil fraud determination result in a monetary penalty for the taxpayer pursuant to Code Sec. 6663, but it can also lead to other collateral consequences, including extending the time the IRS has to assess a tax, limiting the taxpayer’s ability to discharge tax debts in

bankruptcy, and exposing the taxpayer to other miscellaneous penalties.

Code Sec. 6501(a) generally requires the IRS to assess a tax within three years after a return was filed. But Code Sec. 6501(c)(1) states that, where a taxpayer has filed a “false or fraudulent return with the intent to evade tax,” there is no period of limitations, and the tax “may be assessed ... at any time.” The determination of whether the IRS timely assessed a tax can turn on a finding that a tax return was filed under fraudulent pretenses—that is, if a court finds that a return is not imbued with fraud, then the IRS’ tax assessment related to that return must comply with the general timing requirements of Code Sec. 6501(a).¹⁸

A fraudulent return for purposes of Code Sec. 6501(c)(1) is a return “prepared with intent to evade tax believed to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of tax.”¹⁹ The analysis of fraudulent intent for purposes of determining whether a taxpayer filed a fraudulent return under Code Sec. 6501(c) is generally the same as the analysis undertaken for purposes of determining the applicability of a civil fraud penalty under Code Sec. 6663.²⁰ And, at least in some jurisdictions, even if the taxpayer does not possess fraudulent intent when filing their return, if his or her tax return preparer or advisor possessed fraudulent intent when preparing or filing a tax return (or providing advice that is translated onto the return), such intent can open the statute of limitations for assessment with regard to that tax year.²¹ However, other courts have found that the taxpayer, rather than the preparer or advisor, must have the intent to evade tax in order for the statute of limitations to be extended under Code Sec. 6501(c).²²

Another consequence of a civil tax fraud determination can be found in the Bankruptcy Code, which provides that

any debt “for a tax or a customs duty with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such a tax” is not dischargeable in a bankruptcy proceeding.²³ While certain tax debts can be wiped away in bankruptcy, tax debts that flow from a fraudulent return do not qualify for such relief. So, a finding of civil tax fraud can have consequences that extend well beyond the Code and its associated regulations.

Finally, beyond the fraud penalty under Code Sec. 6663, the Code contains several other provisions that allow the IRS to further sanction specific fraudulent taxpayer behaviors with monetary penalties, including, but not limited to, a provision that allows the IRS to penalize taxpayers for fraudulent acknowledgments with respect to donations of motor vehicles.²⁴

Conclusion

Taxpayers should carefully review their filings for accuracy before filing. Ultimately, however, taxpayers should not fear that a simple mistake, though potentially costly in terms of accuracy-related penalties, will result in a steep penalty for civil tax fraud. Rather, civil fraud requires more: specifically, proof that the taxpayer willfully intended to avoid a tax obligation.

If a taxpayer is under investigation or accused of fraudulent conduct, he or she may want engage counsel to help him or her understand the options with regard to interfacing with the IRS to resolve such allegations. Practitioners should understand the risks associated with a finding of civil tax fraud, including the potential for dual-tracked proceedings of civil and criminal tax fraud, and the collateral consequences of a fraud determination.

ENDNOTES

¹ References to the “Code” and “Section” refer to the Internal Revenue Code of 1986, as amended.

² Code Sec. 6662(b)(2).

³ Code Sec. 6662(b)(1).

⁴ *J. Edelson*, CA-9, 87-2 USTC ¶9547, 829 F2d 828, 833; *Minchem Int’l. Inc.*, 109 TCM 1273, Dec. 60,267(M), TC Memo. 2015-56, at *15, *aff’d sub nom. J.J. Sun*, CA-5, 2018-1 USTC ¶50,133, 880 F3d 173.

⁵ *L.T. Zell*, CA-10, 85-2 USTC ¶9698, 763 F2d 1139, 1142-43; *W.E. Mitchell*, CA-5, 41-1 USTC ¶9317, 118 F2d 308, 310.

⁶ *See, e.g.*, T.C.R. 142(b) (burden of proof for fraud); Code Sec. 7454(a).

⁷ *R.M. Temple*, 80 TCM 611, Dec. 54,104(M), TC Memo. 2000-337, at *8.

⁸ *D.D. Vanover*, 103 TCM 1418, Dec. 58,990(M), TC Memo. 2012-79, at *3 (quoting *J.R. DiLeco*, 96 TC 858, 873, Dec. 47,423 (1991)).

⁹ *W. Norris*, 102 TCM 26, Dec. 58,694(M), TC Memo. 2011-161, at *5.

¹⁰ *G.S. Harrington*, 122 TCM 116, Dec. 61,908(M), TC Memo. 2021-95, at *10.

¹¹ *Id.* Note that fraudulent failure to file a tax return is also conduct subject to penalty under Code Sec. 6651.

¹² *D.D. Vanover*, 103 TCM 148, Dec. 58,990(M), TC Memo. 2012-79, at *3.

¹³ *W. Norris*, 102 TCM 26, Dec. 58,694(M), TC Memo. 2011-161, at *5.

¹⁴ *Id.*
¹⁵ *P.E. Niedringhaus*, 99 TC 202, 211, Dec. 48,411 (1992).

¹⁶ *SCT*, 498 US 192 (1991). While *Cheek* was a criminal case, courts have applied its holding in civil matters. *See, e.g.*, *R.L. Porter*, 110 TCM 1, Dec. 60,339(M), TC Memo. 2015-122.

¹⁷ *K. Allen*, CA-9, 91-1 USTC ¶50,080, 925 F2d 348, 353.

¹⁸ *U.R. Neely*, 116 TC 79, 85, Dec. 54,241 (2001).

¹⁹ *Scenic Trust*, Dec. 62,501(M), TC Memo. 2024-85, at *9.

²⁰ *See P.W. Browning*, 102 TCM 460, Dec. 58,803(M), TC Memo. 2011-261, at *10.

²¹ *S. Murrin*, Dec. 62,411(M), TC Memo. 2024-10, *1, *appeal docketed*, No. 24-2037 (3d Cir. June 12, 2024).

²² *See BASR P’ship*, CA-FC, 2015-2 USTC ¶50,412, 795 F3d 1338 (2015).

²³ 11 USC §523.

²⁴ Code Sec. 6720.



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