

Practice

Common Badges of Tax Fraud Uncovered

By Charles P. Rettig

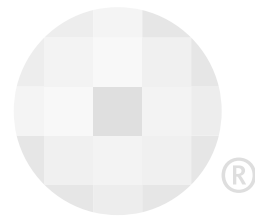
Tax practitioners must be sensitive to the process by which an IRS civil tax examination might wind its way through the administrative system to imposition of a civil fraud penalty or, perhaps, to a recommendation for criminal prosecution by the Department of Justice. Identifying the decision-makers and the factors they consider important may have an impact on the ultimate resolution of the examination.

The conduct of the taxpayer during an examination can rapidly transform a civil inquiry into a criminal investigation. There is no substitute for mastering the facts and anticipating which, if any, “badges of fraud” may arise so as to be able to prepare a cogent response during a civil IRS examination. Filing current year returns during the examination requires extreme judgment since they will have an impact, although not always a taxpayer-favorable impact, on the process. Of equal importance, counseling a client not to perpetuate possible badges of fraud during the examination, including falsifying, destroying or altering records, continuing questionable practices into the present and future years, or transferring or concealing assets may be the difference between a civil resolution and a criminal referral.

Civil Tax Fraud

“If any part of any underpayment of tax required to be shown on a return is due to fraud,” Code Sec. 6663(a) imposes a penalty of 75 percent of the portion of the underpayment due to fraud. A civil fraud penalty case may be developed based on facts and circumstances of a civil examination or result from a criminal investigation (CI) initiated case.

Fraud is generally defined to include intentional wrongdoing designed to evade tax believed to be due and owing.¹ The existence of fraud is a question of fact to be resolved upon consideration of the entire record.² Fraud is not to be presumed or based upon mere suspicion.³ Fraud can’t be imputed or presumed—the government must prove by affirmative evidence that an understatement of tax set forth on the return is attributable to fraud. However, because direct proof of a taxpayer’s intent is rarely available, fraudulent intent may be established by circumstantial evidence and reasonable inferences.⁴ Fraud will generally involve



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one or more of deception, misrepresentation of material facts, false or altered documents, or evasion (*i.e.*, diversion or omission).⁵

Intent is distinguished from inadvertence, reliance on incorrect technical advice, honest difference of opinion, negligence or carelessness.⁶ For taxpayers who argue a good-faith reliance on their accountant or lawyer, the IRS will analyze whether the taxpayer actually followed the advice given or made a full disclosure of the relevant facts to their professional. The IRS will also consider the tax sophistica-

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tion, education, training and experience of the taxpayer, whether there was any attempt to transfer or conceal assets either before or during the audit, and whether the amounts involved as well as the time period at issue were so substantial as to negate a claim of innocence or mistake. Reliance on a tax professional is a proper defense to the imposition of penalties, as the Supreme Court has observed:

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place (citations omitted). "Ordinary business care and prudence" do not demand such actions.⁷

Fraud includes deception by misrepresentation of material facts, or silence when good faith requires expression, which results in material damage to one who relies on it and has the right to rely on it. Tax fraud is often defined as an intentional wrongdoing, on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be due. A determination of tax fraud requires both a tax due and owing as well as fraudulent intent to impose civil penalties.

Avoidance of Tax Is Not a Criminal Offense

"Tax avoidance" generally refers to legally permissible conduct to reduce one's tax liability while "tax evasion" refers to willfully and knowingly fraudulent actions designed to reduce one's tax liability. Taxpayers have the right to reduce, avoid or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and pre-plans events to reduce or eliminate tax liability within the parameters of the law. Evasion involves some affirmative act to evade or defeat a tax, or payment of tax. Examples of affirmative acts of evasion might include deceit, subterfuge, camouflage, concealment, attempts to color or obscure events or to make things seem other than they are. A classic description of "tax avoidance" was penned by Judge Learned Hand:

Anyone may arrange his affairs that his taxes shall be as low as possible. He is not bound to choose the pattern which best pays the Treasury, there is not even a patriotic duty to increase one's taxes. Over and over again courts have said that there is nothing sinister in so arranging affairs has to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right, for nobody owes a public duty to pay more than the law demands.⁸

Clear and Convincing Evidence Required

Civil fraud penalties will only be asserted when the IRS believes there is clear and convincing evidence to prove that some part of the underpayment of tax was due to fraud. Such evidence must show the taxpayer's intent to evade the assessment of tax which the taxpayer believed to be due. Intent is distinguished from inadvertence, reliance on incorrect technical advice, honest difference of opinion, negligence or carelessness. In the case of a joint return, intent must be established for each spouse separately as required by Code Sec. 6663(c). The fraud of one spouse cannot be used to impute fraud by the other spouse. Thus, the civil fraud penalty may be asserted on one spouse only.⁹

Fraud Technical Advisors

During a civil examination, an IRS Fraud Technical Advisor (FTA) may be involved to assist in developing a potential fraud case. The FTA will be consulted in all cases

involving potential criminal fraud, as well as those cases that have potential for a civil fraud penalty.¹⁰ The FTA serves as a resource and liaison to compliance employees in all operating divisions. The FTA is available to assist in fraud investigations and offer advice on matters concerning tax fraud. Upon initial recognition of indicators of fraud, the IRS examiner will discuss the case at the earliest possible opportunity with his/her manager. If the compliance group manager concurs, the FTA will be contacted immediately; and both the compliance group manager and FTA will provide guidance to the compliance employee on how the examination should proceed.

The Kovel Accountant and the Sensitive Issue Audit

In civil tax audits that include potentially sensitive issues, taxpayers often engage a team of representatives, including counsel and a forensic accountant. Engagement of the accountant by counsel should extend the attorney-client privilege to advice rendered by the accountant pursuant to the engagement.¹¹ Although Code Sec. 7525 extended common law protections of confidentiality to tax advice rendered between a taxpayer and a federally-authorized tax practitioner (accountants, *etc.*, to the extent such communications would be considered privileged if they occurred between a taxpayer and counsel), this statutory privilege only applies to noncriminal tax matters before the IRS and noncriminal tax proceedings in federal court.

Unfortunately, this statutory privilege is not available when it is truly needed the most—when a civil tax proceeding moves into the criminal arena. It also may not be available in certain state-related tax proceedings, or nontax civil litigation. However, if the accountant is appropriately engaged by counsel, the common law attorney-client privilege should apply to all communications rendered in furtherance of the legal services being provided to the client, both during the investigative stages of the audit and, if necessary, during any subsequent civil or criminal litigation. This privilege does not extend to the actual return preparation.

Counsel's engagement of the accountant should be in writing, and should indicate that the accountant is acting under the direction of counsel in connection with counsel's rendering of legal services to the client, communications between the accountant and the client are confidential and are made solely for purposes of enabling counsel to provide legal advice; the accountant's work papers are held solely for counsel's use and convenience and subject to counsel's right to demand their return; and the accountant is to

segregate their work papers, correspondence and other documents gathered during the course of the engagement and designate such documents as property of counsel.

The critical inquiry is often whether counsel should retain the taxpayer's prior accountant or a new accountant. Many practitioners prefer to engage a new accountant to avoid the necessity of delineating between nonprivileged communications (communications prior to counsel's

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engagement of the accountant), and privileged communications (communications following counsel's engagement of the accountant).

In an IRS-sensitive issue examination, the IRS will follow up on all leads identified as fraud indicators (signs or symptoms), securing copies of all relevant data relating to indicators of fraud and noting from whom and when obtained. Original documents obtained from the taxpayer or third parties should not be marked, indexed, hole-punched or in any way altered by the IRS compliance employee. Also, it is critical that the compliance employee attempt to secure the taxpayer's explanation(s) for any discrepancies.

Most civil fraud cases involve individual and business taxpayers with poor or nonexistent internal controls and/or where there is little or no separation of duties. When these occur, there is a greater potential for material misstatement of taxable income than in cases involving individuals earning salaries and wages. However, fraud may be present in any type of tax return. In cases where a return has not been filed and fraud is suspected, the IRS representative is instructed not to demand a return from the taxpayer.

Unusual, inconsistent or incongruous items will alert the IRS examiner to the possibility of fraud and the need for further investigation. Taxpayer evasiveness or misconduct during the examination is an early warning sign of possible fraudulent conduct. The method of operating a business (*i.e.*, lack of internal controls, dealing in cash, *etc.*) may be indicative of improperly filed tax returns.

The initial taxpayer contact by the IRS examiner provides the opportunity to obtain valuable information, which may not be readily available later. Indications of fraud may be disclosed to the IRS examiner in discussions,

financial activities and nonresponsive answers. IRS examination work papers will include identification of who prepared the information used to complete the tax return, who approved and classified expense items, who deposited business receipts and how business gross receipts, per the tax return, were determined.

The IRS examiner will typically search behind the books and probe beneath the surface to validate and determine the consistency of information provided and statements made to evaluate the credibility of evidence and testimony provided by the taxpayer. If fraud is discovered, it is important for the IRS to determine who is responsible for the fraudulent act(s)—the taxpayer, the tax return preparer or both. If the taxpayer is not responsible, then neither criminal and/or civil fraud penalties will apply.

The QAR and the Civil Fraud Exception

In some situations, a timely filed amended return—a “qualified amended return” (QAR)—may reduce or eliminate accuracy-related penalties, but will not eliminate potential civil fraud penalties associated with the originally filed return. For accuracy-related penalty computation purposes, the “amount shown as the tax by the taxpayer on his return” includes an amount shown as additional tax on a QAR, except that such amount is not included if it relates to a fraudulent position on the original return.¹² Generally, the QAR regulations are intended to encourage voluntary compliance by permitting taxpayers to avoid accuracy-related penalties if an amended return is generally filed before the IRS begins an examination of the taxpayer or of the promoter of a transaction in which the taxpayer participated.¹³

A QAR can be filed if the taxpayer has not been contacted by the IRS even though he was contacted by others. Also, the IRS contact must be “with respect to the return.” An initial IRS contact does not always identify the exact reason for the contact. Also, a contact for one tax year should not bar the filing of a QAR for a different tax year.

A QAR effectively eliminates accuracy-related penalties by removing amounts shown on the amended return from the penalty calculation. Significantly, even if timely, an amended return does not qualify as a QAR if the tax deficiencies that are corrected in the amended return relate to a fraudulent position on the original return. Why? Taxpayers should be encouraged to voluntarily amend all returns, even returns that for some reason may be deemed to include fraudulent positions, before the occurrence of any IRS contact of the taxpayer. Historically,

the IRS rarely examined amended returns setting forth a deficiency. The IRS is presently conducting examinations of good-faith QARs and is aggressively seeking interviews of the taxpayer, the return preparer and others. What is an appropriate interview response as to the reason a taxpayer decided to amend a return and report an additional tax liability? Patriotism? Sleep therapy? Should we care?

Common Badges of Fraud

Circumstances that may indicate fraudulent intent, commonly referred to as “badges of fraud,” include: (1) understatements of income (*e.g.*, omissions of specific items or entire sources of income, failure to report relatively substantial amounts of income received) particularly if part of a consistent pattern of underreporting over several years; (2) maintaining inadequate records or accounting irregularities (*e.g.*, two sets of books, false entries on documents); (3) giving implausible or inconsistent explanations of behavior or other acts of the taxpayer evidencing an intent to evade tax (*e.g.*, false statements, destruction of records, transfer of assets); (4) concealing income or assets; (5) failing to cooperate with tax authorities; (6) engaging in illegal activities; (7) providing incomplete or misleading information to one’s tax preparer; (8) lack of credibility of the taxpayer’s testimony; (9) filing false documents, including false income tax returns; (10) failing to file tax returns; and (11) dealing in cash.¹⁴ No single factor is dispositive; however, the existence of several factors “is persuasive circumstantial evidence of fraud.”¹⁵

Some factors have no application in a particular matter while other factors may be regarded as neutral. Fraud does not exist where the circumstances merely lead to a suspicion of fraud.¹⁶ Typically, in litigation, the court will determine whether, on balance, the “badges of fraud” demonstrate that the taxpayer acted with fraudulent intent for each tax year at issue. The IRS Fraud Handbook sets forth a nonexclusive list of various indicators of potentially fraudulent conduct, including the following¹⁷:

Indicators of Fraud—Income

- Omitting specific items where similar items are included
- Omitting entire sources of income
- Failing to report or explain substantial amounts of income identified as received
- Inability to explain substantial increases in net worth, especially over a period of years
- Substantial personal expenditures exceeding reported resources

- Inability to explain sources of bank deposits substantially exceeding reported income
- Concealing bank accounts, brokerage accounts and other property
- Inadequately explaining dealings in large sums of currency, or the unexplained expenditure of currency
- Consistent concealment of unexplained currency, especially in a business not routinely requiring large cash transactions
- Failing to deposit receipts in a business account, contrary to established practices
- Failing to file a tax return, especially for a period of several years, despite evidence of receipt of substantial amounts of taxable income
- Cashing checks, representing income, at check cashing services and at banks where the taxpayer does not maintain an account
- Concealing sources of receipts by false description of the source(s) of disclosed income, and/or nontaxable receipts

Indicators of Fraud—Expenses or Deductions

- Claiming fictitious or substantially overstated deductions
- Claiming substantial business expense deductions for personal expenditures
- Claiming dependency exemptions for nonexistent, deceased, or self-supporting persons. Providing false or altered documents, such as birth certificates, lease documents, school/medical records, for the purpose of claiming the education credit, additional child tax credit, earned income tax credit (EITC), or other refundable credits
- Disguising trust fund loans as expenses or deductions

Indicators of Fraud—Books and Records

- Multiple sets of books or no records
- Failure to keep adequate records, concealment of records or refusal to make records available
- False entries, or alterations made on the books and records; back-dated or post-dated documents; false invoices, false applications, false statements or other false documents or applications
- Invoices are irregularly numbered, unnumbered or altered
- Checks made payable to third parties that are endorsed back to the taxpayer. Checks made payable to vendors and other business payees that are cashed by the taxpayer

- Variances between treatment of questionable items as reflected on the tax return, and representations within the books
- Intentional under- or over-footing of columns in journal or ledger
- Amounts on tax return not in agreement with amounts in books
- Amounts posted to ledger accounts not in agreement with source books or records
- Journalizing questionable items out of correct account
- Recording income items in suspense or asset accounts
- False receipts to donors by exempt organizations

Indicators of Fraud—Allocations of Income

- Distribution of profits to fictitious partners
- Inclusion of income or deductions in the tax return of a related taxpayer, when tax rate differences are a factor

Indicators of Fraud—Conduct of Taxpayer

- Testimony of employees concerning irregular business practices by the taxpayer
- Destruction of books and records, especially if just after examination was started
- Transfer of assets for purposes of concealment, or diversion of funds and/or assets by officials or trustees
- Pattern of consistent failure over several years to report income fully
- Proof that the tax return was incorrect to such an extent and in respect to items of such magnitude and character as to compel the conclusion that the falsity was known and deliberate
- Payment of improper expenses by or for officials or trustees
- Willful and intentional failure to execute pension plan amendments
- Backdated applications and related documents
- False statements on Tax Exempt/Government Entity (TE/GE) determination letter applications
- Use of false Social Security numbers
- Submission of false Form W-4
- Submission of a false affidavit
- Attempt to bribe the examiner
- Submission of tax returns with false claims of withholding (Form 1099-OID, Form W-2) or refundable credits (Form 4136, Form 2439) resulting in a substantial refund
- Intentional submission of a bad check resulting in erroneous refunds and releases of liens
- Submission of false Form W-7 information to secure Individual Taxpayer Identification Number (ITIN) for self and dependents

- False statement about a material fact pertaining to the examination. Attempt to hinder or obstruct the examination. For example, failure to answer questions; repeated cancelled or rescheduled appointments; refusal to provide records; threatening potential witnesses, including the examiner; or assaulting the examiner
- Failure to follow the advice of accountant, attorney or return preparer
- Failure to make full disclosure of relevant facts to the accountant, attorney or return preparer. The taxpayer's knowledge of taxes and business practices where numerous questionable items appear on the tax returns

Indicators of Fraud— Methods of Concealment

- Inadequacy of consideration
- Insolvency of transferor
- Asset ownership placed in other names
- Transfer of all or nearly all of debtor's property
- Close relationship between parties to the transfer
- Transfer made in anticipation of a tax assessment or while the investigation of a deficiency is pending
- Reservation of any interest in the property transferred
- Transaction not in the usual course of business
- Retention of possession or continued use of asset
- Transactions surrounded by secrecy
- False entries in books of transferor or transferee
- Unusual disposition of the consideration received for the property
- Use of secret bank accounts for income
- Deposits into bank accounts under nominee names
- Conduct of business transactions in false names

Warning Signs of a Criminal Referral

A long, unexplained period of silence after much investigative activity by the IRS examiner should cause a degree of concern that an FTA has been consulted. Since civil examiners are extremely discreet about informing the taxpayer's representative that they are contemplating a criminal referral, experienced representatives have learned to identify certain activities by the agent, prior to the period of silence, as indicating a potential referral to CI. In cases involving allegations of unreported income, the examiner's request and summoning and photocopying of all bank account information could raise the specter of a criminal referral, especially if the agent has stumbled upon a "side account" which was not accounted for in determining the taxpayer's income. By summoning the

information, the examiner ensures that the case file will include copies of bank statements, deposited items, deposit slips, bank wire confirmations and canceled checks, which could be evidence of the unreported income.

A civil examiner's questions about the taxpayer's "lifestyle," expenditures and other information may indicate that the agent is undertaking a financial status type of an examination¹⁸ to determine whether the income reported on the return supports the taxpayer's financial lifestyle. If the examiner requests information as to the taxpayer's assets and liabilities at the beginning and end of a tax year, this could suggest that the agent has determined that the taxpayer's books and records do not adequately reflect income and that an indirect method of proof of income, such as a net worth method, is being considered. The net worth and expenditures methods are well-recognized indirect methods of proof that have often been used in reconstructing income in criminal tax cases.¹⁹

A taxpayer's representative may be alerted when the examiner requests information such as supplier invoices, price lists, customer ledger cards and other information that could be used as circumstantial evidence to prove unreported gross receipts. Also, if the examiner requests the taxpayer either to submit to an interview or to answer questions in writing that relate to the taxpayer's knowledge or intent of the facts and circumstances surrounding alleged unreported income or false deductions; or the examiner refuses to discuss in detail the status of the audit and the possibility of concluding the audit in the near future, a criminal referral may be under consideration.

Knowing When to Hold 'em or Fold 'em

Can you actually determine whether a civil examination will result in a criminal investigation? Can you predict the future? Civil examinations involving sensitive issues must be handled cautiously. Amending returns before or during an examination might be the last link necessary for a civil examination to be referred to CI for a criminal investigation. Taxpayers who are aware of questionable issues within their returns and are not under examination should consider filing a QAR to avoid the exposure to the accuracy-related penalties. When representing a taxpayer considering or following submission of a good-faith QAR, the representative should proceed with extreme caution.

An examination that uncovers egregious facts may result in a civil fraud penalty (or less) while another involving a sympathetic situation might result in a criminal prosecution.

Both will involve an often-frustrating process that, by itself, may destroy the personal relationships and business affairs of the taxpayer. Proper development and analysis of relevant

facts and circumstances in a civil examination involving potentially sensitive issues requires considerable effort and judgment, at every stage of the examination.

ENDNOTES

¹ *J.M. Potter*, 107 TCM 1101, Dec. 59,820(M), TC Memo. 2014-18 (Jan. 27, 2014); *U.R. Neely*, 116 TC 79, 86, Dec. 54,241 (2001).

² *A.W. Pittard Est.*, 69 TC 391, 400, Dec. 34,775 (1977).

³ *C. Petzoldt*, 92 TC 661, 699-700, Dec. 45,566 (1989).

⁴ *R.D. Grossman, Jr.*, CA-4, 99-2 ustr ¶150,631, 182 F3d 275, 277-78, *aff'd*, 72 TCM 845, Dec. 51,589(M), TC Memo. 1996-452.

⁵ IRM 25.1.6.3 (Oct. 30, 2009).

⁶ IRM 25.1.6.1 (Oct. 30, 2009).

⁷ *R.W. Boyle*, Sct, 85-1 ustr ¶13,602, 469 US 241,

251, 105 Sct 687; *A.J. Henry*, CA-9, 99-1 ustr ¶150,363, 170 F3d 1217, 1220.

⁸ *E.F. Gregory v. Helvering*, CA-2, 1934 CCH ¶9180, 69 F2d 809, 810, *aff'd*, Sct, 35-1 ustr ¶9043, 293 US 465.

⁹ IRM 25.1.1.1 (Jan. 23, 2014).

¹⁰ IRM 25.1.6.1 (Oct. 30, 2009).

¹¹ *L. Kovel*, CA-2, 62-1 ustr ¶9111, 296 F2d 918.

¹² Reg. §1.6664-2(c)(2).

¹³ Reg. §1.6664-2(c)(3).

¹⁴ *M.R. Spies*, Sct, 43-1 ustr ¶9243, 317 US 492, 499, 63 Sct 364; *K.J. Morse*, 86 TCM 673, 675, Dec. 55,366(M), TC Memo. 2003-332, *aff'd*,

CA-8, 2005-2 ustr ¶150,533, 419 F3d 829; *R.W. Bradford*, CA-9, 86-2 ustr ¶9602, 796 F2d 303, 307-08, *aff'd*, 49 TCM 105, Dec. 41,615(M), TC Memo. 1984-601; *J.E. Meier*, 91 TC 273, 297-98, Dec. 44,995 (1988). *Potter*, *supra* note 1.

¹⁵ *D.D. Vanover*, 103 TCM 1418, 1420-21, Dec. 58,990(M), TC Memo. 2012-79.

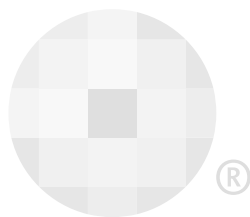
¹⁶ *R.B. Parks*, 94 TC 654, 664, Dec. 46,545 (1990).

¹⁷ IRM 25.1.2.3 Indicators of Fraud.

¹⁸ See Code Sec. 7602(e).

¹⁹ IRM 9.5.8.6.2 Net Worth Investigation (Mar. 19, 1999); *M.L. Holland*, Sct, 54-2 ustr ¶9714, 348 US 121, 75 Sct 127.

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