Penalties

The Civil Fraudulent Failure to File Penalty: When It Applies and When It Does Not

By Stow Lovejoy

Two recent Tax Court cases, *E.J. Kernan*[1] and *J.R. Banister*,[2] illustrate both the use of the fraudulent failure to file penalty under Code Sec. 6651(f) against "tax protesters" and the difficulties in applying the penalty. The cases are quite close in their facts, but give different results, one case applying the penalty and the other not. In each case, the penalty was imposed on a tax protester who marketed tax nonfiling arguments and followed his own advice. But in one case the protester avoided the fraudulent failure to file penalty through a good-faith, if mistaken, belief, while in the other case the protester suffered the penalty, perhaps because he chose not to testify.

Fraudulent Failure to File and Badges of Fraud

The fraudulent failure to file penalty is an increase in the general failure to file penalty under Code Sec. 6651. Code Sec. 6651(a)(1) provides, in relevant part:

> In case of failure ... to file any return required ... on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

Code Sec. 6651(f) provides for a threefold increase in the penalty for a fraudulent failure to file:

> If any failure to file any return is fraudulent, paragraph (1) of subsection (a) shall be applied –
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> (1) by substituting "15 percent" for "5 percent" each place it appears, and
> (2) by substituting "75 percent" for "25 percent."

STOW LOVEJOY, Esq., is Of Counsel at Kostelanetz & Fink, LLP in New York City.

Thus, the fraudulent failure to file penalty is 15 percent for each month for which a taxpayer fraudulently fails to file a return, to a maximum of 75 percent.

The fraudulent failure to file penalty was enacted as part of the Improved Penalty Administration and Compliance Tax Act, or "IMPACT," itself a part of the Omnibus Budget Reconciliation Act of 1989.[3] The legislative history of IMPACT explains the purpose and application of the new fraudulent failure to file penalty:

> The committee has made this modification to improve the coordination of the failure to file penalty with the accuracy-related penalties. The committee intends that the courts and the IRS should consider the same elements when considering the imposition of this new aspect of the penalty as is done under present law when considering imposition of the 6653 penalty where there has been a failure to file a return. Thus, the actions or behavior that trigger the penalty under the bill are to be the same as those under present law.[4]

In order for the 15-percent per-month Code Sec. 6651(f) penalty to apply, the failure to file must be "fraudulent." The taxpayer must have intended to evade a tax he or she believed to be owing.[5] Under Code Sec. 7454(a) and Tax Court Rule 142(b), the IRS bears the burden of proof of fraud by clear and convincing evidence. Because it is difficult to prove fraudulent intent by direct evidence, the IRS may establish fraud by circumstantial evidence, which includes various "badges of fraud."[6] These badges of fraud include, but are not limited to:

> (1) understating 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; (8) lack of credibility of the taxpayer's testimony; (9) filing false documents; (10) failing to file tax returns; and (11) dealing in cash.[7]

The badges are meant to show conduct that is indicative of fraudulent intent.

Like the fraud penalty under Code Sec. 6663, the government must show the taxpayer intended "to evade taxes known to be owing by conduct intended to conceal, mislead or otherwise prevent the collection of taxes."[8] However, to hold a taxpayer liable for the 6651(f) penalty, the government must show that the intentional conduct was a deliberate omission: the failure to file a tax return.[9] ("The taxpayer must *deliberately* fail to file his return on the date due, knowing that, by doing so, he is concealing the fact that he has income subject to tax.") In a Code Sec. 6663 penalty case, the government must show that the taxpayer intentionally filed a fraudulent tax return; in a Code Sec. 6651(f) penalty case, the government must show that the taxpayer intentionally, and fraudulently, did not file a tax return.

Cases involving the fraudulent failure to file penalty are relatively few; this paucity may reflect the difficulty of proving the intent to mislead by *not* filing a return. The IRS appears to have found one fruitful area for the application of the penalty: "tax protesters" and others who refuse to file returns based on frivolous arguments. While the sample is probably not broad enough to be statistically significant, of the 13 Tax Court decisions concerning the fraudulent failure to file penalty in 2013 and 2014, seven involved "tax protesters" or others making frivolous arguments, and the IRS prevailed in six. Of the six nonprotester decisions, the IRS prevailed in four, and fraudulent intent was not at issue in those four cases because the taxpayer defaulted by not appearing, or because fraud was conclusively established in a prior criminal proceeding.

Kernan

In *Kernan*, a tax protester avoided the fraudulent failure to file penalty. Eugene Kernan apparently made a living from counseling people on how not to pay taxes and assisting them in not paying. He owned a website that sold materials explaining how to avoid paying taxes, he set up entities to help persons avoid their taxes, and he assisted clients involved in IRS examinations. He had been engaged in these activities since 1995.

Kernan didn't file tax returns for the years 1994 and following. His reason for not filing was based on his interpretation of Code Sec. 6001, which he interpreted to mean that he did not have to file a tax return unless and until the IRS notified him in writing that he must do so. He never received such notice.[10] Kernan had consistently held this belief and communicated it to various governmental bodies. He wrote to the Social Security Administration, the Commissioner of Internal Revenue and the Secretary of the Treasury asking for clarification. He never received a reply that specifically addressed his questions. He also shared his views widely, including appearing on a television news program advocating his belief.

The IRS investigated Kernan's income tax liability starting with the tax year 2001. Kernan refused to turn over any records, so the agent determined his gross income using bank records showing deposits into his personal bank account. The IRS prepared substitutes for returns

under Code Sec. 6020(b), issued notices of deficiency for the tax years 2001 through 2006 and included additions to tax under Code Sec. 6651(f).

In the Tax Court, Kernan did not contest the IRS's deficiencies other than to repeat his argument that he did not have to file a tax return or pay tax until he received notice. The court disposed of his arguments in short order: "Mr. Kernan is required to file a tax return, even without a personal invitation to do so."[11] The court found that the IRS had offered sufficient evidence to connect Kernan with the unreported income, and sustained the deficiencies. Then the court considered the fraudulent failure to file penalties.

The court noted that to apply the increased 15-percent per-month penalty, the IRS had to prove by clear and convincing evidence that the taxpayer had underpaid his taxes for each year and that some part of the underpayment was due to fraud.[12] After quickly finding that Kernan had underpaid his taxes, the court reviewed what the IRS must prove: "that the taxpayer deliberately failed to file, and also, that by failing to file, the taxpayer intended to evade tax that he knew was owed."[13] The relevant determination was Kernan's belief and intent at the time he decided not to file.

The IRS established a number of the badges of fraud by clear and convincing evidence: Kernan had failed to file tax returns; he had failed to make estimated tax payments; he did not maintain adequate records; and he did not cooperate with tax authorities, both by his repeated failed attempts to quash IRS summons and his refusal to produce business records. On the other hand, a number of other badges were absent: Kernan had not filed false documents, had not engaged in illegal activity, had not hidden assets or income, and did not have two sets of books nor dealt in cash. Kernan had provided no implausible or inconsistent explanation of his behavior, he didn't understate his income because he never filed an income tax return, and because he had no return preparer, there was no preparer not to be forthright with. Finally, although Kernan held himself out as a tax professional, he had no special education or expertise, and demonstrated it by his conclusions about return filing requirements.

Against these badges of fraud, the court weighed what it considered Kernan's "good faith belief" in his arguments. The case closely resembled *H.R.G. Raney*,[14] in which the Tax Court stated that "a good faith misunderstanding can exist even if the misunderstanding is objectively unreasonable," and that the IRS must provide evidence to "clearly and convincingly negate the [taxpayer's] implicit claim that he was acting on his good faith understanding of the law."[15] The court stated that it had not been convinced by clear and convincing evidence that Kernan's beliefs were not held in good faith. "The frivolity of his legal arguments is not enough, even when added to the badges of fraud present in this case, to establish fraudulent intent by clear and convincing evidence."[16] The IRS's fraudulent failure to file penalties were not sustained.

Banister

On facts very similar to *Kernan*, the Tax Court sustained a fraudulent failure to file penalty in *Banister*. Joseph Banister had received a degree in accounting, was a CPA and had worked as a Special Agent for the IRS Criminal Investigation Division for six years. In 1999, he wrote a book called Investigating the Federal Income Tax: A Preliminary Report, presenting a variety of arguments why citizens were not obligated to pay federal income tax. The arguments included that paying taxes was voluntary, that the 16th Amendment was not legally ratified, and that government financing operations were unconstitutional. Banister thereafter provided "tax consultation services" and published his views on income tax.

The IRS Office of Professional Responsibility disqualified Banister from practicing before the IRS for "disreputable conduct." He lost an administrative appeal within the IRS, sued for reinstatement in the U.S. District Court, and appealed the District Court's denial to the Ninth Circuit. At each of the four levels of review, Banister asserted his arguments as to why citizens need not pay income tax, and the arguments were rejected as frivolous and as having been "universally dismissed." The Court of Appeals specifically rejected Banister's assertion that his "good faith belief" in his positions was a defense to willfulness. Citing *J.L. Cheek*,[17] the court stated: "Violating a tax statute because one believes the statute is invalid constitutes a 'refus[al] to utilize the mechanisms provided by Congress to present ... claims of invalidity,' and the state of mind behind such a refusal does not offer a defense to willfulness."[18]

As Banister contested his disqualification from practicing before the IRS, the IRS examined his taxes for the tax years 2003 through 2006. He did not produce complete and accurate books and records, and resisted summons of his bank records. The IRS was able to reconstruct his income from bank deposits and prepare substitutes for returns. In its notices of deficiency, the IRS added fraudulent failure to file penalties.

Banister contested the deficiency in the Tax Court, asserting that his income was not subject to tax and repeating the arguments that had led to his disqualification to practice before the IRS. However, he refused to testify at trial, citing his Fifth Amendment privilege against self-incrimination. The court brushed aside the frivolous

arguments that he had once again made and affirmed the deficiencies. It then turned to the fraudulent failure to file penalties.

The court found many of the same badges of fraud as in *Kernan*: a longtime failure to file returns, failure to report substantial amounts of income, failure to maintain adequate records and failure to cooperate with the taxing authorities. The court also found "implausible or inconsistent explanations of behavior," presumably "implausible," as it appears that Banister was amazingly consistent in his arguing that he did not owe tax for various Constitutional and statutory reasons. In addition, the court found that Banister's education and experience were further evidence that he acted with fraudulent intent.[19] Finally, the court noted that because he refused to testify, Banister had shown no plausible nonfraudulent explanation for his behavior. The court pointed out that "his persistence in discredited arguments in the face of unanimous rulings by the courts negates good faith."[20] With no defense, the penalties were affirmed.

Consistency Rewarded? Or Just Good Press?

Kernan and *Banister* present very similar facts, yet the taxpayer was able to avoid the fraudulent failure to file penalty in one case, but not the other. Both taxpayers marketed tax avoidance schemes based on frivolous arguments. Both taxpayers followed their own advice and did not file returns, based on the frivolous arguments that they marketed. Both were found to exhibit the same badges of fraud, although Banister had the additional badge of expertise in the tax law. In *Kernan*, the IRS did not clearly and convincingly negate the taxpayer's implicit claim that he was acting on a good-faith understanding of the law, whereas in *Banister*, the IRS apparently did. Whether the taxpayer had a good-faith misunderstanding, as an element of intent, must be determined at the time of the failure to file.[21] Thus, the IRS's and courts' later rejections of Banister's frivolous arguments should not, as the Tax Court suggested, negate good faith.[22] The key distinction appears to have been whether there was external evidence to support the finding of good faith. The court found that Kernan had "acted consistently with his belief before, during and after the years at issue. ... He wrote multiple letters to Government agencies asking them for clarification."[23] His appearance on a local television news program touting his analysis apparently was also persuasive of good faith. Banister, by contrast, asserted a Fifth Amendment right not to testify, and therefore offered no additional facts to support good faith. While he had consistently presented his discredited arguments before the IRS and in court, there were no other facts to support a finding of good faith to prevent the inference of fraud from the badges presented.

Perhaps the lesson to be learned from these cases is that strong evidence of a good-faith belief that a return is not required is better than staying silent. Of course, one who breaks his silence by testifying waives his rights under the Fifth Amendment of the Constitution and risks having his testimony used against him. It appears taxpayers must accept that risk if they wish to convince the court that they are merely wrong-headed but not fraudulent.

ENDNOTES

1 *E.J. Kernan,* 108 TCM 503, Dec. 60,071(M), TC Memo. 2014-228.
2 *J.R. Banister,* 109 TCM 1047, Dec. 60,211(M), TC Memo. 2015-10.
3 Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) (Dec. 19, 1989).
4 H.R. Rep. 101-247, at 1402–03 (Sept. 20, 1989).
5 *D.G. Clayton*, 102 TC 632, 647, Dec. 49,784 (1996); *C.P. Recklitis*, 91 TC 874, 909, Dec. 45,154 (1988).
6 *See R.W. Bradford*, CA-9, 86-2 USTC ¶9602, 796 F2d 303, 307; *J.R. DiLeo*, 96 TC 858, 875, Dec. 47,423 (1991).
7 *A. Mohamed*, 106 TCM 537, Dec. 59,685(M), TC Memo. 2013-255, at *32–*33.
8 *DiLeo, supra* note 6, 96 TC, at 874.
9 *Mohamed, supra* note 7, TC Memo. 2013-255, at *21.
10 *Kernan, supra* note 1, TC Memo. 2014-228, at *5.
11 *Id.,* at *18.
12 *Id.,* at *20.
13 *Id.*, at *21.
14 *H.R.G. Raney,* 80 TCM 321, Dec. 54,029(M), TC Memo. 2000-277.
15 *Id.,* TC Memo. 2000-277, at *2.
16 *Kernan, supra* note 1, TC Memo. 2014-228, at *30.
17 *J.L. Cheek,* SCt, 91-1 USTC ¶50,012, 498 US 192, 111 SCt 604.
18 *J.R. Banister*, CA-9, 2012-2 USTC ¶50,680, 499 FedAppx 668.
19 *Banister, supra* note 2, TC Memo. 2015-10, at *11.
20 *Id.,* at *12.
21 Because the fraudulent act is the failure to file, the fraudulent intent must be determined at the time of the decision not to file. *Mohamed*, *supra* note 7, TC Memo. 2013-255, at *22, citing *M. Enayat*, 98 TCM 436, Dec. 57,988(M), TC Memo. 2009-257, at *24.
22 *Banister, supra* note 2, TC Memo. 2015-10, at *12.
23 *Kernan, supra* note 1, TC Memo. 2014-228, at *30.