YOU CAN'T MAKE TAX STUFF UP: A LOOK AT THE CIVIL FRAUD PENALTY

Posted on **March 16, 2017** by **Jim Malone**

The Internal Revenue Code provides for penalties to deter taxpayers from underreporting their income, claiming bogus deductions, and engaging in other forms of misbehavior. For example, there is a twenty percent accuracy-related penalty that applies when a taxpayer negligently fails to follow regulations, materially understates his tax liability, or files a return with a substantial valuation misstatement. I.R.C. § 6662(a). That twenty percent penalty can be doubled if the return rests upon a gross valuation misstatement. I.R.C. § 6662(h).

For taxpayers who cross the line dividing negligent behavior from willful misconduct, there is a seventy-five percent fraud penalty. I.R.C. § 6663(a). The fraud penalty applies in situations where the taxpayer acted intentionally in an effort to evade tax liability. *See, e.g.*, *Cole v. Comm'r*, 637 F.3d 767, 780 (7th Cir. 2011). To sustain the penalty, the IRS must establish fraud through clear and convincing evidence. *Id.* As a consequence, cases involving the fraud penalty are relatively infrequent. They often follow a conviction for tax evasion because collateral estoppel will typically establish the required elements. *See, e.g.*, *Anderson v. Comm'r*, 698 F.3d 160, 164-65 (3d Cir. 2012).

While a conviction for evasion will support a fraud penalty assessment, it is not required. Last week, a district judge in Utah readily sustained a fraud penalty assessment in a case involving a taxpayer who filed a return claiming losses derived from a non-existent investment. *Omega Forex Group v. United States*, No. 2:14-CV-00915-BSJ, 2017 U.S. Dist. LEXIS 33289 (D. Utah Mar. 8, 2017).

The taxpayer, Robert Flath, had claimed a $149,857 loss on his tax return for 1998, which represented his share of loss sustained by Omega Forex Group, LC. 2017 U.S. Dist. LEXIS 33289 at *2. While the K-1 that Flath attached to his return indicated that he had contributed $200,000 in capital during the tax year, the records of Omega Forex Group simply showed a note receivable in that amount. *Id.* That was a problem, since it meant that Flath had no money at risk and therefore could not deduct the associated loss. *See* I.R.C. § 465(a)(1) (limiting deduction associated with trade or business to amounts at risk), (c)(3) (excluding amounts borrowed from related parties from amount at risk). And for good measure, Flath denied signing the note. 2017 U.S. Dist. LEXIS 33289 at *2. Accordingly, as the district court observed, "[w]hen Flath signed his 1998 tax return on March 25, 1999, his purported $200,000 capital contribution used as the basis to allocate his loss was non-existent." *Id.* at *2-*3.

In an effort to fill this hole, Flath asserted that he had begun the process of transferring $165,000 in marketable securities to Omega Forex Group in December 1998. The court identified several problems with this contention:

- *First*, the shares were not liquidated until 1999;
- *Second*, their value as of December 1998 was not sufficient to support the loss claimed on the return;
- *Third*, the $165,000 wound up in a nominee account in the Cayman Islands, where Flath used a portion of it to pay tuition for one of his children.

Id. at *3-*4.

Flath also argued that he had relied upon his accountant to prepare his return properly. The accountant, however, had sent Flath a letter indicating that she was preparing the return in reliance upon Flath's assurance that he had the amount of the loss at risk, and Flath never told her that about the nominee account. *Id.* at *4.

For the following tax year, the pattern was similar: Flath claimed a loss of $85,793 even though he still had no funds at risk; the K-1 attached to his return reflected a $100,000 capital contribution that never occurred. *Id.* at *4-*5. The only wrinkle for this tax year was that Flath's nominee account had been augmented by payments of premiums associated with a captive insurance arrangement that provided a secondary malpractice policy to his dental practice for a monthly premium of $8000, an amount well in excess of his primary policy that cost $1400 annually. *Id.* at *5 & n.17. Even these funds were not put at risk: Flath was free to remove funds from the nominee account at any time. In fact, as of the end of 1999, he only had $35,950.20 on deposit, even though his purported capital account balance in Omega Forex Group was $64,088. *Id.* at *5.

Against that background, the district judge had little trouble sustaining the fraud penalty assessment. In the court's view, Flath knew he had not made capital contributions and knew that the only funds he had committed remained available to him; in fact he used those funds for a variety of purposes. *Id.* at *6.

Flath is not a sympathetic figure. While the promoter of this arrangement presumably told him that it would pass muster, he was still responsible for the accuracy of the statements made on his return. And it is hard to imagine any plausible justification for listing a fictitious transaction on a tax return.

By: Jim Malone

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. Learn more about Post & Schell's Tax Controversy Practice >>

This entry was posted in **Blog** and tagged **Civil fraud penalty**, **tax procedure** by **Jim Malone**. Bookmark the **permalink [http://taxcontroversyposts.postschell.com/cant-make-tax-stuff-look-civil-fraud-penalty/]** .