

Comments

Civil Tax Penalties: Changes and Recommendations

I. INTRODUCTION

The concept of our federal revenue system is based upon the principle of self enforcement. It depends upon the honest disclosure of income, deductions, and exemptions by over 150 million taxpayers who file their individual, corporate, and fiduciary federal income tax returns yearly.¹ Consequently, the self-assessing individual taxpayer has the ultimate responsibility in preparing his federal income tax returns.

Furthermore, as long as our tax laws are based upon the principle of self enforcement, the temptation for the unsupervised taxpayer to falsify his income tax returns and pay less than due is substantial and frequently persuasive.² A cursory examination of the cases reflect how persuasive this temptation can be. Examples of these cases include not only the "stereotyped dishonest gangster,"³ but also the "stereotyped honest citi-

1. Civil and criminal tax penalties pertain not only to income taxes, but also to other federal taxes. Examples of such include gift taxes, *United States v. Alker*, 260 F.2d 135 (3d Cir. 1958); excise taxes, *United States v. Linenberg*, 179 F. Supp. 808 (D.C. Pa. 1959); admission taxes, *United States v. H.J.K. Theatre Corp.*, 236 F.2d 502 (2d Cir. 1956); social security and withholding taxes, *Wilson v. United States*, 250 F.2d 312 (9th Cir. 1958); and wagering taxes, *United States v. Shaffer*, 291 F.2d 689 (7th Cir. 1961). Reference to the aforementioned kinds of taxes are hereinafter referred to as "tax laws".

2. No one really knows how prevalent tax evasion is. Statistical studies seem to be lacking. However, a not too recent study by the Internal Revenue Service contained some interesting conclusions. For example, errors on taxpayer's tax returns occurred two out of every five in 1965, 85% of them in the taxpayers favor. Furthermore, this study reflected approximately 51% of the subjects questioned believed almost every taxpayer would cheat if he thought he could get away with it. INTERNAL REVENUE SERVICE, *The Role of Sanctions in Tax Compliance*, Sept. 1968 (Unpublished).

3. *United States v. Rubino*, 431 F.2d 284 (6th Cir. 1970). Alleged Mafia enforcer living in Detroit.

zen," involving judges,⁴ lawyers,⁵ doctors,⁶ accountants,⁷ mayors,⁸ insurance brokers,⁹ and university professors.¹⁰ Consequently, it is necessary for the Internal Revenue Service [hereinafter the "Service"] to discourage this temptation and encourage compliance with the tax laws by penalizing the underpaying taxpayer. Mr. Justice Grier, over a century ago, succinctly stated the rationale for the imposition of tax penalties upon underpaying taxpayers.

The purpose of penalties inflicted upon persons who attempt to defraud the revenue, is to enforce the collection of duties and taxes. They act in *terrorem* upon parties whose conscientious scruples are not sufficient to balance their hopes of profit.¹¹

Accordingly, the Service has available at its disposal a wide variety of tax penalties, both civil and criminal, to "act in *terrorem*" upon underpaying taxpayers, thereby encouraging compliance with the tax laws. It is the purpose of this article to examine the most commonly known and most frequently encountered civil tax penalties, including an examination of recent recommendations adopted by the Administrative Conference of the United States¹² [hereinafter "The Conference"]. Said recommendations are designed to improve the effectiveness and fairness of the civil tax structure by restructuring certain key civil tax penalties.¹³

4. *United States v. Polack*, 442 F.2d 446 (3d Cir. 1971) (New Jersey county judge, for failure to file).

5. *United States v. Ming, Jr.*, 466 F.2d 1000 (7th Cir. 1972); Sellin, *Professional Responsibility of the Tax Practitioner*, 52 TAXES 584 (1974). Lawyers seem to be frequently involved in violations of the tax laws.

6. *United States v. D'Anna*, 450 F.2d 1201 (2d Cir. 1971).

7. *United States v. Washburn*, 488 F.2d 139 (5th Cir. 1973).

8. *United States v. Miriani*, 422 F.2d 150 (6th Cir. 1970) (Mayor of Detroit).

9. *United States v. Haseltine*, 419 F.2d 579 (9th Cir. 1970).

10. *United States v. Parks*, 411 F.2d 1171 (1st Cir. 1969).

11. *Dorsheimer v. United States*, 74 U.S. 166, 173 (1868).

12. The Administrative Conference of the United States [hereinafter "the Conference"] was established as a permanent independent agency by the Administrative Conference Act enacted in 1964. The purpose of the Conference is to develop improvements in the legal procedures by which federal agencies administer regulatory government programs. Although the Conference may only recommend changes in administrative procedures, the Chairman is authorized to encourage the departments and agencies to adopt the recommendations of the Conference and is required by the Administrative Conference Act to transmit to the President and to Congress an annual report and interim reports concerning the activities of the Conference, including reports on the implementation of its recommendations. Recommendations adopted by the Conference may call for new legislation or for action on the part of affected agencies. A substantial number of recommendations have been implemented and others are in the process of implementation. See OFFICE OF FEDERAL REGISTRY, NATIONAL ARCHIVES AND RECORDS SERVICE, GENERAL SERVICES ADMINISTRATION, UNITED STATES GOVERNMENT MANUAL 462 (1977-1978).

13. INTERNAL REVENUE SERVICE, *Internal Revenue Service Procedures: Civil Penalties* Recommendation 75-7, 41 Fed. Reg. 3984 (1976). [Hereinafter,

II. CIVIL AND CRIMINAL TAX PENALTIES COMPARED

Since the focus of a tax fraud investigation may change at any time from civil to criminal, it is important to briefly compare the interplay between the two basic types of penalties. Tax penalties can be divided into two groups: civil, sometimes referred to as ad valorem penalties,¹⁴ and criminal, sometimes referred to as specific penalties.¹⁵

Ad valorem penalties are assessed by the Commissioner of the Service and added to the existing liability.¹⁶ They are considered additions to the tax due and owing, measured by the percentage of the total tax liability.¹⁷ Hence, ad valorem penalties are solely monetary in nature. Conversely, specific penalties are not added to and assessed by the Commissioner but are imposed only by successful prosecution instituted by the Justice Department.¹⁸ Since specific penalties take the form of fines and/or imprisonment, they are not measured by a percentage of the total tax liability but are applied as a fixed or specific sum to certain types of misconduct.¹⁹ It should also be noted that these two types of penalties are not mutually exclusive in that the same offense may result in the imposition of both ad valorem and specific penalties. Moreover, a conviction on a criminal charge does not bar the imposition of ad valorem penalties, and conversely, an acquittal on a criminal charge does not bar the same.²⁰

references will be made to the text of the Conference's report of "Recommendation 75-7", and not to the Federal Register.]

14. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 55.01 (1976 revision); Powell v. Gleason, 74 P.2d 47, 50 (Ariz. 1937); Annot., 114 A.L.R. 838 (1937).

15. *Id.* Arthur v. Johnston, 194 S.E. 151, 154 (S.C. 1937).

16. The constitutionality of whether Congress may delegate the penalty assessment power to an administrative agency was decided long ago. The constitutionality was attacked on the basis that imposition of the penalty entitled the taxpayer to a jury trial. The Court held otherwise, for the reason that enforcement of the tax laws was the primary purpose of the penalty since it was remedial and not punitive in purpose. Hence, an administrative officer could properly enforce such penalties, e.g. the Commissioner. McDowell v. Heiner, 15 F.2d 1015 (3d Cir. 1926); Helvering v. Mitchell, 303 U.S. 391 (1938). Subsequently, it was held that the Seventh Amendment did not entitle one to a jury trial where ad valorem penalties are involved.

17. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 55.01 (1976 revision).

18. *Id.* Ledbetter v. Bailey, 274 F. 375 (W.D.N.C. 1921).

19. *Supra*, note 18 at § 55.01.

20. Hanby v. Comm'r, 67 F.2d 125 (4th Cir. 1933). Proof of a criminal conviction is sufficient evidence to sustain the imposition of the 50% civil fraud penalty when asserted for the same years. The taxpayer is collaterally estopped from

III. CIVIL PENALTIES

The most commonly known and frequently encountered civil penalties are those imposed for failure to file a return or to pay the tax [hereinafter the "delinquency penalty"],²¹ for failure to pay the tax because of negligence or intentional disregard to the rules and regulations [hereinafter the "negligence penalty"],²² and for failure to pay the tax because of fraud with intent to evade payment [hereinafter the "civil fraud penalty"].²³

Those who may be held liable for civil penalties include more than the simple delinquent taxpayer who fails to file his tax return. Civil penalties may also apply to persons who are under a *special duty to perform a particular act*. Examples of such include the following: employees in a corporation,²⁴ partners in a partnership,²⁵ both the corporation and one or more of its officers,²⁶ private foundations,²⁷ and trusts.²⁸

In comparing the interplay between civil penalties, it is important to note that delinquency and negligence penalties may be concurrently imposed, which are referred to as pyramiding penalties.²⁹ On the other hand, the imposition of the civil fraud penalties precludes the imposition of the delinquency or negligence penalties.³⁰ Consequently, no pyramiding is permitted when the civil fraud penalty is applied even though the factual situation may permit such application.³¹

denying fraud, and therefore, it is res judicata. *Tomlinson v. Lefkowitz*, 334 F.2d 262 (5th Cir. 1964); *Thomas J. McLaughlin*, 29 B.T.A. 247 (1933); MERTENS, LAW OF FEDERAL INCOME TAXATION, § 55.01 (1976 revision). See also *Helvering v. Mitchell*, 303 U.S. 391 (1938). Mr. Justice Brandeis, for the Court, analyzed the nature of the civil fraud penalty and concluded that an acquittal in a previous criminal fraud action against the taxpayer would not be res judicata in a subsequent civil suit by the government for tax deficiencies arising out of fraud, and hence, there would be no double jeopardy. His rationale was that civil penalties are deemed additions to the original tax due and owing, are considered remedial in nature, and are only intended to indemnify the government for the taxpayer's misconduct. Therefore, the restrictions of double jeopardy, quantum of proof, jury trial, and other features of criminal law are not applicable to the Commissioner.

21. I.R.C. § 6651.

22. *Id.* § 6653(a).

23. *Id.* § 6653(b).

24. *Carding Grill, L.T.D.*, 38 B.T.A. 669 (1938); *Morrow*, [1967] TAX CT. MEM. DEC. (CCH) 242; *Erie Coca Cola Bottling Co.*, 1 B.T.A. 531 (1925).

25. I.R.C. § 6671(b); *Calvey v. United States*, 448 F.2d 177 (6th Cir. 1971); *Marcello*, [1969] TAX CT. MEM. DEC. (CCH) 189.

26. *J.J. Dix, Inc. v. Comm'r*, 223 F.2d 436 (2d Cir. 1955).

27. I.R.C. § 6652(d); *Treas. Reg. § 301.6652-2(b)*; I.R.C. § 6685.

28. I.R.C. § 6652(d)(i); *Treas. Reg. § 301.6652-2(c)*.

29. *Robinsons Dairy v. Comm'r*, 302 F.2d 42, 45 (10th Cir. 1962).

30. *Treas. Reg. § 301.6653-1(b)(2)*.

31. An example of where such a factual situation may trigger the imposi-

A. *The Delinquency Penalty*

In the event of a failure to file a tax return on or before the prescribed due date, the Internal Revenue Code of 1954 [hereinafter "the Code"]³² provides a penalty to be imposed at 5% per month³³ based on the net amount due, not to exceed 25%. Pursuant to the 1969 Tax Reform Act, the Code also provides a penalty for failure to pay the income tax shown on the return on or before the prescribed due date³⁴ and for failure to pay a tax deficiency within 10 days of notice and demand.³⁵

The penalty will not be imposed, notwithstanding the fact of a failure to pay, provided the taxpayer can affirmatively show that his failure to pay arose as a result of "reasonable cause and not due to willful neglect."³⁶ Furthermore, whenever two or more delinquency penalties apply, the combination of such can never exceed the maximum of 25% due to a limitation expressly provided in the Code.³⁷ However, this limitation does not apply until the maximum penalty of 25% is reached. Until then, the possibility for imposing the maximum penalty of 25% increases accordingly when two or more combinations of different delinquency penalties apply. It is also important to parenthetically note that this particular penalty does not require a certain "state

tion of either the civil fraud penalty or the delinquency penalty arises when the taxpayer fails to file his tax return because he disliked the administration and adopted a belligerent and non-cooperative attitude toward the investigating agent. The failure to file coupled with the "badge of fraud" of non-cooperativeness triggered the civil fraud penalty to the exclusion of the delinquency penalty. *Powell v. Granquist*, 252 F.2d 56 (9th Cir. 1958). *See also*, Otis Blackwell, [1965] TAX CT. MEM. DEC. (CCH) 252; Oswill M. Cummings, Jr., [1968] TAX CT. MEM. DEC. (CCH) 52.

32. I.R.C. § 6651(a)(1).

33. The Internal Revenue Code of 1954 defines a month as a calendar month where a return is required to be filed on the last day of any month. If a return is required to be filed on any day within a month, the period terminating on the corresponding day of the calendar month is considered a month. This was not true of the Internal Revenue Code of 1939 since it defined a month on a thirty day basis. For example, the period of delinquency in the case of a corporation income tax return due on March 15 but filed on April 15, is now one month, 31 calendar days. Under the Code of 1954, only a 5% penalty applies as opposed to the 10% penalty under the Code of 1939. *Treas. Reg. 301.6651-1(a)(2)*.

34. I.R.C. § 6651(a)(2).

35. I.R.C. § 6651(a)(3).

36. I.R.C. § 6651(e)(1); *Treas. Reg. 301.6651-1(a)*. For a discussion of reasonable cause *see text infra* page 472.

37. I.R.C. § 6651(c)(1). For example, if the failure to file penalty (5-25%) and

of mind" before it is imposed. The failure is sufficient in and of itself to trigger the penalty.

(1) The Deficiency Requirement—Unpaid Tax

There must be a deficiency or unpaid tax for the delinquency penalty to apply. This is determined by the amount required to be shown on the tax return reduced by: (a) the amount of any part of the tax which is paid on or before the original due date, and (b) the amount of any credit against the tax which may be claimed on the return.³⁸ For example, any prepayments of income tax liability, either through withholding or through payments of estimated tax liability, would reduce the net amount upon which the delinquency penalty would be computed. Likewise, a *net operating loss carryforward* excuses the delinquency imposed for the *subsequent year*³⁹ to the extent that it reduces or eliminates the deficiency or unpaid tax. On the other hand, a *net operating loss carryback* does not excuse the delinquency penalty imposed for the *earlier year*⁴⁰ even though it reduces or eliminates the deficiency or unpaid tax. This holding is based on the rationale that it would be unfair to allow a future loss to reduce or possibly eliminate a past wrong, i.e. past failure to file or pay.

In light of the above, it becomes apparent that this is the first logical stage of examination when contesting the imposition of the delinquency penalty. Counsel should closely scrutinize the alleged deficiency not only to reduce the taxable amount upon which the original tax will be based, but also to reduce or possibly eliminate the amount upon which the penalty will be computed.

(2) Sufficiency of the Tax Return

In order to avoid the imposition of the delinquency penalty, it is necessary not only to file a timely tax return, but to file a tax return which sufficiently complies with the official forms and regulations. A sufficient return is one giving substantial information as to the specific items of the taxpayer's gross income,

the failure to pay penalty (1/2-25%) applies to any month, the failure to file penalty for that month (5%) is reduced by the failure to pay penalty for that month (1/2%). When the failure to file penalty (5%) and the failure to pay an assessed deficiency applies (1/2%), the failure to pay the deficiency is reduced by the amount of the failure to file penalty attributable to the assessed deficiency.

38. I.R.C. § 6651(b); Treas. Reg. § 301.6651-1(b).

39. *Goodwin Crockery Co.*, 37 T.C. 355 (1961), *aff'd on other grounds*, 315 F.2d 110 (6th Cir. 1963); *Dorfman v. Comm'r*, 394 F.2d 651 (2d Cir. 1968).

40. Rev. Rul. 72-484; *C.V.L. Corp.*, 17 T.C. 812 (1951); *Nick v. Dunlap*, 185 F.2d 674 (5th Cir. 1951).

deductions, and credits to which he is entitled.⁴¹ Perfect accuracy and completeness is not necessary to constitute a sufficient return provided it purports to be a return, sworn as such, and reflects an honest good faith endeavor to satisfy the law.⁴²

An examination of the appropriate case law indicates certain factual situations where sufficiency of a tax return becomes critical in determining whether a delinquency penalty is applicable. Examples of such involve incomplete or inadequate returns,⁴³ wrong or different returns,⁴⁴ unauthorized signatures of other spouse on a joint return,⁴⁵ returns signed for the taxpayer by the preparer,⁴⁶ corporate returns,⁴⁷ and proof of filing of a return.⁴⁸ A concise rule of law cannot be drawn from the aforementioned factual situations since the cases have been decided primarily on questions of fact and not of law.

41. *Comm'r v. Lane-Wells Co.*, 321 U.S. 219 (1944). *David Meade Peebles*, [1956] TAX CT. MEM. DEC. (CCH) 160, *aff'd per curiam on other grounds*, 249 F.2d 92 (4th Cir. 1957). A return with absolutely no information on it except a taxpayer's name, address, and an arbitrary amount labeled as tax due cannot be regarded as a "return" within the meaning of the Code.

42. *Zellerback Paper Co. v. Helvering*, 293 U.S. 172 (1934).

43. I.R.C. § 6061; *Jessee Ullman Reaves*, 31 T.C. 690 (1958), *aff'd*, 295 F.2d 336 (5th Cir. 1959). An unsigned return will not constitute filing of a return.

44. *Comm'r v. Lane-Wells Co.*, 321 U.S. 219 (1944). The filing of a corporate return on Form 1120 would not relieve a personal holding company of its duty to file a personal holding company return on Form 1120H. *See also*, *Pike Holding Co.*, 11 T.C.M. (CCH) 110 (1952). Inadvertent use or use in good faith of the wrong form of return where all material facts are disclosed may avoid the delinquency penalty.

45. *Miller v. Comm'r*, 237 F.2d 830 (5th Cir. 1956). A return is sufficient although signed and filed by a wife on behalf of her husband with his authority, but without a power of attorney. For further authority clarification, see I.R.C. § 6013(b)(3)(A).

46. *Albert K. Tossas*, [1955] TAX CT. MEM. DEC. (CCH) 114; *Howard Davis*, [1955] TAX CT. MEM. DEC. (CCH) 87. A return is insufficient when it is not signed by taxpayer himself, but by his accountant who prepared it. *But see*, *Miller v. Comm'r*, note 45 *supra*.

47. I.R.C. § 6062; *A. Brigham Rose*, *aff'd per curiam*, 188 F.2d 355 (9th Cir. 1951). A corporate return, not verified by anyone and not signed by a duly authorized officer, is not a sufficient return.

48. The taxpayer has the burden of proof to show filing occurred within the statutory period. *Belsen v. Comm'r*, 174 F.2d 386 (4th Cir. 1949). The following factors are important in determining whether there was a timely filing:

(a) taxpayer's honesty (including his past record of all proper filings) *Thomas Watson*, [1945] TAX CT. MEM. DEC. (P-H) 1091.

(b) introduction of copies of the alleged returns and the proof of payment thereon, *Otho J. Sharpe v. Comm'r*, 249 F.2d 447 (6th Cir. 1957).

(c) The reliability of I.R.S. records relating to the return in question. *Ruth W. Oppenheimer*, 16 T.C. 515 (1951); in light of the above cases, it is recommended

(3) Statute of Limitations

The statute of limitations begins to run from the date the tax return is filed, not from the date it is due.⁴⁹ Therefore, in the case of the delinquency penalty, the statute is tolled until a tax return is filed.⁵⁰ This is crucial since a tax return may not be filed for several years after its due date, if it is filed at all. Furthermore, the statute is tolled if the tax return is deemed insufficient; this emphasizes the importance in considering the issue of sufficiency of a return.

(4) Reasonable Cause—A Defense

Although a taxpayer becomes delinquent by failing to file or pay his tax return, he may nonetheless avoid the imposition of the delinquency penalty provided he makes an affirmative showing that his failure was due to “reasonable cause and not due to willful neglect.”⁵¹ Since the burden of proof rests on the taxpayer,⁵² it is incumbent upon him to show more than a mere absence of willful neglect. He must also show the delinquency arose due to reasonable cause,⁵³ and in absence of such a showing, the imposition of the delinquency penalty remains mandatory.⁵⁴

The regulations define “reasonable cause” as follows:

If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause.⁵⁵

that tax returns be mailed either through certified or registered mail with return receipt requested.

49. See note 44, *supra*.

50. I.R.C. § 6501(c)(3).

51. I.R.C. § 6651(a)(1).

52. *Lee v. Comm’r*, 227 F.2d 181 (5th Cir. 1955); *William M. Bebb*, 36 T.C. 170 (1961); *Frank Delaney*, [1961] TAX CT. MEM. DEC. (CCH) 310; *Breland v. United States*, 323 F.2d 492 (5th Cir. 1963), when the taxpayer did not sustain his burden of proving reasonable cause for failure to file returns merely by saying he had no income.

53. *Lee v. Comm’r*, 227 F.2d 181, 184 (5th Cir. 1955).

While we agree with the taxpayers that there is no affirmative evidence that the delayed filing was deliberate, this will not avail them as a defense as this is not the language of the statute. It, on the contrary, provides that the penalty is to be assessed unless reasonable cause for not filing is shown, and it has been held repeatedly that whether there is reasonable cause for failure to file a timely return is a question of fact in respect to which the burden is on the petitioner.

See also *West Virginia Steel Corp.*, 34 T.C. 851, 860 (1960). A mere showing that delinquency was not due to willful neglect will not suffice. The taxpayer must also show reasonable cause. Penalty was sustained.

54. *Buford Oil Co. v. Comm’r*, 153 F.2d 745 (5th Cir. 1946).

55. *Treas. Reg. § 301.6651-1(c)*. For further discussion on the concept of reasonable cause, see *Annot.*, 3 A.L.R. 2d 617 (1970). *Reisner, Relief from Delinquency Penalties; The Internal Revenue Code*, 98 U. PA. L. REV. 183 (1949).

This definition is too general in form and, therefore, breeds ambiguity. As a result, the Service has formulated specific standards for establishing reasonable cause⁵⁶ which, however, have not proved to be an exhaustive remedy for the definitional shortcomings of the regulations. Consequently, it is necessary to consult case law for greater clarity regarding the factual situations which have constituted reasonable cause.⁵⁷

For example, a taxpayer may not invoke the defense of reasonable cause when his failure arose as a result of simple forgetfulness,⁵⁸ illness,⁵⁹ or ignorance of the law⁶⁰ (even though the

56. II CCH INTERNAL REVENUE MANUAL-AUDIT, REASONABLE CAUSE § 4350 at 7637 (1977).

The following eight specific causes for failure to file a return within the time prescribed by law, if clearly established by the taxpayer, will be accepted as reasonable.

(a) Where the return was mailed in time (whether or not the envelope containing the return had sufficient postage) to reach the District Director's office in normal course of mails within the legal period.

(b) Where the return was filed within the legal period but in the wrong district, or directly in the Regional Commissioner's or Commissioner's office.

(c) Where the delay or failure to file was due to erroneous information given the taxpayer by an Internal Revenue officer or employee.

(d) Where the delay was caused by death or serious illness of the taxpayer or serious illness in his/her immediate family.

(e) Where the delay was caused by unavoidable absence of the taxpayer.

(f) Where delinquency was caused by the destruction by fire or other casualty of the taxpayer's place of business or business records.

(g) Where the taxpayer, prior to the time for filing return, made an application to the District Director's office for proper blanks and these were not furnished him/her in sufficient time to permit the executed return to be filed on or before its due date.

(h) Where the taxpayer proves that he/she personally visited the office of the District Director or a local office before the expiration of the time within which to file return for the purpose of securing information or aid to properly make out his/her return, and through no fault of his/her own was unable to see the representative of the Service.

57. The difficulty of the concept of reasonable cause is that it defies definition with any significant degree of precision. It is comparable to the difficulty encountered in the area of common law tort involving the standard of the average reasonable man. In as much as reasonable cause is incapable of being specifically defined, it would be hazardous to draw a conclusion from any one particular case as to whether a reasonable cause may be established to defeat the imposition of the delinquency penalty. The test remains essentially a question of fact for the lower court to decide. *Estate of Fish v. Comm'r*, 203 F.2d 358 (6th Cir. 1953); *Sanders v. Comm'r*, 225 F.2d 629 (10th Cir. 1955); *Stevens Bros. Foundation, Inc. v. Comm'r*, 324 F.2d 633 (8th Cir. 1963); *Comm'r v. Walker*, 326 F.2d 261 (9th Cir. 1964).

58. *Rogers Hornsby*, 26 B.T.A. 591 (1932); *Charles Rice*, 14 T.C. 503 (1950). See also *Carnie-Gaudie Mfg. Co.*, 18 B.T.A. 893 (1930), where a tax return was

taxpayer is a non-resident of the United States⁶¹). Furthermore, lack of necessary information (books and records),⁶² growing business and personal problems,⁶³ lack of funds to hire an accountant to prepare the return,⁶⁴ lack of funds to pay the tax,⁶⁵ constitutional objections to paying taxes for war purposes because of religious sympathies,⁶⁶ and wife's assumption husband would prepare and sign her return⁶⁷ have all been held insufficient to successfully establish the defense of reasonable cause.

However, the issue of reasonable cause becomes further complicated when the factual element of *reliance* is encountered. When a taxpayer relied upon his employee whose duty it is to file the return and said employee fails to make a timely filing, reasonable cause may or may not be sufficient to withstand the imposition of the delinquency penalties.⁶⁸

Furthermore, when a taxpayer relied upon *advice* from another party, the sufficiency of reasonable cause may depend upon any one or combination of some of the following factors: the advice should be specific and not general;⁶⁹ the taxpayer should in fact rely on said advice;⁷⁰ the adviser should be competent or qualified;⁷¹ all relevant facts should be disclosed;⁷² and the degree of education and intelligence of the taxpayer,

delinquent as a result of a clerical oversight by a taxpayer with a good reputation.

59. Alma Williams et. al., 16 T.C. 893 (1951). *But see*, Gladys Forbes Est., 12 T.C.M. (CCH) 176 (1953) (Mental incompetent, penalty was avoided).

60. Nirosta Corp., 8 T.C. 987 (1947); Stevens Bros. Foundation, Inc., 39 T.C. 93 (1962) (Taxpayer mistakenly believed that no return was due or that it was due on a later date).

61. In Rafael Sabatini, 32 B.T.A. 705, *aff'd, rev'd, and modified in part*, 98 F.2d 753 (2d Cir. 1938). Taxpayer, though a non-resident alien, was represented in the United States and "undoubtedly could" have obtained a ruling as to the taxable status of payments received, so that there was no reasonable cause for not making a return.

62. Bech Chemical Corp., 27 T.C. 840 (1957). Taxpayer alleged lack of knowledge of actual earnings, but the penalty was sustained.

63. Marion H. Bell, [1957] TAX CT. MEM. DEC. (CCH) 201; Gasman, [1967] TAX CT. MEM. DEC. (CCH) 42.

64. Flint & Fulton, Inc., [1956] TAX CT. MEM. DEC. (CCH) 252.

65. Jones, 25 T.C. 1100 (1956).

66. Owens, [1968] TAX CT. MEM. DEC. (CCH) 4.

67. Folsen, Jr., [1973] TAX CT. MEM. DEC. (CCH) 98.

68. Bouvelt Realty, Inc., 46 B.T.A. 45 (1942). *See* Pioneer Auto Service Co., 36 B.T.A. 213 (1937), where reasonable cause insufficient, penalty was sustained.

69. Cedar Valley Distillery, Inc., 16 T.C. 870 (1951).

70. Genesee Valley Gas Co. v. Comm'r, 180 F.2d 41 (D.C. Cir. 1950).

71. Electroline Sales Co., 10 T.C.M. (CCH) 113 (1950). Penalty was avoided when all facts were made to public accountant of good reputation and tax experience.

72. Haywood Lumber and Mining Co. v. Comm'r, 178 F.2d 769, 771 (2d Cir. 1950). The Tax Court held reasonable cause was not established since the taxpayer did not disclose all relevant facts to his accountant, i.e. that a corporation

particularly in business and tax affairs should be closely scrutinized.⁷³

(5) Recommendations by the Conference⁷⁴

In order to achieve greater effectiveness and fairness when applying the delinquency penalty, the Conference adopted the following recommendations for its restructure.

(a) *Recommendation 75-7(d)(1)(i)*. As discussed above the taxpayer may avoid the imposition of the delinquency penalty provided he affirmatively shows that the delinquency resulted from "reasonable cause and not due to willful neglect."⁷⁵ The Conference recommends that the phrase ". . . and not due to willful neglect" be deleted from the statute.⁷⁶ The Service should implement this particular recommendation since the regulations equate the concept of reasonable cause with the absence of willful neglect, and assume that the establishment of reasonable cause satisfies the lack of willful neglect.⁷⁷ Furthermore, the language "willful neglect" is itself confusing and its substantive value to the statute is dubious. For example, at least one court has held that neglect becomes willful when it is inten-

was a personal holding company. However, the Second Circuit Court reversed Tax Court's holding and thereby placed a limitation on how extensive disclosure of the facts must be in order to establish reasonable cause.

When a corporate taxpayer selects a competent tax expert, supplies him with all necessary information, and requests him to prepare proper tax returns, we think the taxpayer has done all that ordinary business care and prudence can reasonably demand. Sprague had not 'awaited passively for such tax advice' as Wolcott 'might volunteer to give'; he affirmatively requested the preparation by his consultant of proper returns. To require Mr. Sprague to inquire specifically about the personal holding company act nullifies the very purpose of consulting an expert. We doubt if anyone would suggest that a client who stated the facts of his case to his lawyer must, in order to show ordinary business care and prudence, inquire specifically about the applicability of various legal principles which may be relevant to the facts stated. The courts have recognized that reliance on the advice of counsel or of expert accountants, sought and received in good faith is 'reasonable cause' for failing to file a tax return. We think those cases are correctly decided and in principle control the case at bar.

73. *Hermax Co. v. Comm'r*, 185 F.2d 776 (3d Cir. 1949); *Electrolin Sales Co.*, 10 T.C.M. (CCH) 113 (1950).

74. The Conference is the abbreviated form for Administrative Conference of the United States. See note 12 *supra* for an explanation of said agency.

75. See note 51, *supra*.

76. Recommendation 75-7(d)(1)(i).

77. Treas. Reg. § 301.6651-1(c).

tional⁷⁸ (intentional negligence?). The language should therefore be deleted.

(b) *Recommendation 75-7(d)(1)(ii)(a)*. The Conference recommends that the rate of accrual be lowered for the failure to file penalty so that the 5% rate would apply to the first month, and a lesser percentage for every month thereafter, not to exceed 25%. Under the proposed scheme, the monthly rate of the penalty would be extended under three suggested options, so that the 25% maximum penalty would not be reached for 11 months, 16 months, or 21 months, respectively,⁷⁹ instead of the present 5 month maximum. The reason is that the current penalty escalates too quickly in that it deters delinquent taxpayers for only five months. Thereafter, the maximum penalty is reached providing no further incentive or pressure to file the return beyond fear of civil or criminal fraud penalties. To extend the rate of accrual over a period of time longer than 5 months would provide greater incentive to comply with the statute.⁸⁰

The Service's response to this recommendation was unfavorable.⁸¹ The proposal would not change the failure to pay penal-

78. *Oklahoma City Retailers Ass'n v. United States*, 331 F.2d 328 (10th Cir. 1964).

79. *Recommendation 75-7(d)(1)(ii)(a)*.

The monthly rate of the penalty for failure to file a return, established in subsection 6651(a)(1), should be modified so as to extend the time period of lateness in filing a return which must elapse before the rate of penalty to be applied reaches the present aggregate maximum rate of 25 percent. The table below sets forth three options for so modifying the monthly penalty rate, compared with present law.

	Penalty for first month (percent)	Penalty for each succeeding month (percent)	Period of lateness to reach maximum penalty (months)
Present law	5	5	5
Option 1	5	2	11
Option 2	5	1¼	16
Option 3	5	1	21

The penalty for failure to pay tax established by subsection 6651(a)(2) should be imposed in addition to, and not offset against, the foregoing penalty.

80. Assimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 U.C.L.A. L. REV. 637, 673 (1976). This article provides an excellent discussion of the Conference's recommendations. Professor Assimow wrote a consultant's report favoring the Conference's recommendations.

81. INTERNAL REVENUE SERVICE, *Internal Revenue Service's Responses to the Recommendations made by the Administrative Conference of the United States for Improving the Internal Revenue Service Procedures. Civil Penalties. Response to 75-7, July 1976* (Unpublished).

ty, only the failure to file penalty. Consequently, the Service contends that when the limitation between these two penalties is considered, the result is that the present penalty already extends the period of lateness beyond the Conference's three suggested options.⁸² Therefore, the present penalty is "too low to provide a sufficient deterrent to taxpayers who . . . defer payment of taxes." In lieu of the Conference's recommendations, the Service proposed retaining the present rate of accrual per month for the failure to file penalty (5%), while raising the failure to pay penalty to an equal amount, including a similar limitation when both penalties are imposed concurrently.⁸³

Nonetheless, the Service's proposal should not be adopted since the rate of accrual still rises too quickly when the penalty is applied. Raising the failure to pay penalty is too onerous to be fair. The Conference's recommendation that the rate of accrual be extended over a longer period of time should be adopted. However, in view of the present liberal policy in granting automatic extensions for filing income tax returns, the Conference's first suggested option of 11 months should be adopted, instead of 16 or 21 months respectively.

(c) *Recommendation 75-7(d)(1)(ii)(b)*. The Conference recommends that the present penalty, imposing a full month's delinquency charge (5%) upon a taxpayer who is only a fraction of a month delinquent, for example, one day,⁸⁴ should be changed. The change would pro-rate the monthly rate on a semi-monthly

82. See note 81, *supra*.

Section 6651(c) contains the formula for this computation. It directs that for any month in which both penalties apply, the addition for failure to pay (0.5%) is allowed as an offset against the failure to file addition (5%). In other words, during the months when both penalties apply, a maximum of 5 percent per month in penalties can be assessed. Of this amount, 4.5 percent is allocated to the failure to file and 0.5 percent to the failure to pay penalty. As a result, it requires over forty-eight months to reach the combined maximum penalty under existing law.

83. *Id.*

In lieu of the Administrative Conference recommendation, the Service proposes retaining the failure to file penalty at 5 percent per month and raising the failure to pay penalty to an equal amount. Where both penalties are assessable at the same time, the failure to pay penalty would not apply until either the return had been filed without payment or until the date which is five months from the date prescribed for filing, whichever is earliest. This would allow up to ten months to reach the combined maximum penalties, just one month short of the Conference's option 1.

84. See note 33, *supra*.

basis in order to achieve greater fairness when the delinquency is *de minimis*. Nevertheless, the Service disagrees because “. . . administrative problems requiring it to work with smaller interest figures . . .”⁸⁵ would pose too great an administrative burden.

Notwithstanding the administrative burden, the Conference’s recommendation should be adopted. The Service’s burden caused by computing the delinquency on a semi-monthly basis is not an interest sufficient to warrant sacrificing fairness and equity.

(d) *Recommendation 75-7(d)(2)*. The Conference recommends that the Service set forth in the Regulations as opposed to the Internal Revenue Manual,⁸⁶ a list of specific standards establishing reasonable cause for failure to timely file. The Service agrees with this recommendation. However, it may prove additionally helpful to clarify in the Regulations the issue of *reliance*. The Internal Revenue Manual gives little guidance concerning this. It states that “whether it is sufficient excuse that taxpayer relied on advice of counsel that no tax was due or return required, is not subject to an absolute rule.”⁸⁷ At present, the uniformity of case law is insufficient to assist in this regard.⁸⁸

(e) *Recommendation 75-7(e)*. The Conference also recommends that when a delinquency penalty is assessed, the taxpayer be “accorded administrative settlement procedures and the right to Tax Court review.” The rationale is that a taxpayer should have the right to contest this penalty *before payment*, as is true when negligence and civil fraud penalties are assessed.

The Service disagrees on the basis that the “administrative burden” would be too costly.⁸⁹ This burden may be alleviated by amending certain I.R.C. sections which would relieve the Service from duplicating time and energy.

For example, before the Service mails the “90 day letter” to the taxpayer imposing the delinquency penalty, the Service must examine the return to insure there is no deficiency in tax which may be barred from later assessment. This is true because of restrictions on the issuances on subsequent “90 day

85. See note 81, *supra*.

86. See note 56, *supra*.

87. *Id.*

88. See note 72, *supra*.

89. See note 81, *supra*.

letters."⁹⁰ To avoid these restrictions and thereby alleviate unnecessary administrative burdens on the Service, the restrictions should be changed by amending the pertinent code sections⁹¹ in order to permit additional "90 day letters" to be issued when the first letter is related solely to the delinquency penalty.

B. The Negligence Penalty

In the event there is an underpayment of tax and said underpayment is due to "negligence or intentional disregard of rules and regulations, but without intent to defraud,"⁹² a 5% penalty is imposed based on the amount of the underpayment.

(1) Procedural Aspects

The burden of proving due care, thereby rebutting the presumption of negligence, is on the taxpayer.⁹³ However, the Commissioner must specifically allege acts of negligence or the presumption fails.⁹⁴ Furthermore, if the Commissioner does not allege negligence in the alternative when asserting the civil fraud penalty, and if the taxpayer prevails, the court may not assert the negligence penalty on behalf of the Commissioner, even if the facts justify such an assertion.⁹⁵

Also, pyramiding the negligence penalty with the delinquency penalty is allowed⁹⁶ but not when the civil fraud penalty is imposed.⁹⁷ It should be noted that the statute of limitations is not

90. I.R.C. § 6212(c); MERTENS, LAW OF FEDERAL INCOME TAXATION § 49.187 (1976 revision).

91. I.R.C. § 6212(c) and I.R.C. § 6659(b).

92. I.R.C. § 6653(a).

Negligence or intentional disregard of rules and regulations with respect to income or gift taxes. If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by Chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5% of the underpayment.

93. *J.T.S. Brown's Son Co.*, 10 T.C. 840 (1948); *Barton v. Comm'r*, 424 F.2d 1295 (7th Cir. 1970); *George G. Ebner*, [1958] TAX CT. MEM. DEC. (CCH) 108, holding that failure to file a return constituted a disregard of the rules and regulations.

94. *Kilborn*, 29 T.C. 102 (1957).

95. *Guaranty Trust Company v. United States*, 44 F. Supp. 417 (E.D. Wash. 1942), *aff'd*, 139 F.2d 69 (9th Cir. 1943). "It does not lie within the court's power to change the penalties assessed. This is an administrative function."

96. See note 30, *supra*.

97. I.R.C. § 6653(b).

tolled when there is a negligent underpayment or intentional disregarding of the rules and regulations.⁹⁸

(2) The Underpayment of Tax

In order for the negligence penalty to apply, there must be an underpayment of tax. This amount is determined by the difference between the true tax liability and the amount shown on the taxpayer's original return.⁹⁹ The occurrence of a net operating loss carryforward for the subsequent year will prevent the imposition of the penalty to the extent it reduces or eliminates the underpayment. This is not true of a net operating loss carry-back.¹⁰⁰ Furthermore, if any part of the underpayment is due to negligence, the penalty applies to the entire underpayment.¹⁰¹ As in the case of the delinquency penalty, this is the first logical stage of dispute when contesting the imposition of the negligence penalty.

(3) Seeking a Definition of Negligence

Negligence or intentional disregard of the rules and regulations is not defined in the Code or the Regulations. However, the Internal Revenue Manual is helpful in this regard by providing the following definition of negligence:

Negligence, in the generally accepted legal sense, is the omission to do something which a reasonable person, guided by those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable person would not do.¹⁰²

Thus, there emerges a standard which is very similar to the common law of torts, the average reasonable man concept. The resulting test is what a reasonable and ordinarily prudent man would have done under the circumstances, due care.¹⁰³ Inasmuch as the negligence penalty requires the appropriate mental attitude, neglect, the analysis is reduced to questions of fact. Accordingly, there are certain factual situations where the penalty is most likely to arise.

(a) *Adequate Books and Records.* A taxpayer's failure to

98. I.R.C. § 6501(c).

99. See note 30, *supra*.

100. John Welborn Pusser v. Comm'r, 206 F.2d 68 (4th Cir. 1953). See also note 40, *supra*.

101. Abrams v. United States, 449 F.2d 662 (2d Cir. 1971).

102. II CCH, INTERNAL REVENUE MANUAL-AUDIT, NEGLIGENCE § 4560 at 8177 (1976).

103. Southeastern Finance Co. v. Comm'r, 153 F.2d 205 (5th Cir. 1946). See

keep adequate books and records exposes him to the negligence penalty.¹⁰⁴ The question of adequacy must be viewed in the light of the needs and the types of businesses involved.¹⁰⁵ For instance, a small service business may have adequate records based on a checkbook and bank statements. On the other hand, a more complicated business would probably be held negligent if it maintained its records in the same way.

(b) *Understatements of Income or Overstatements of Deductions.* In the absence of an adequate explanation by the taxpayer, a significant understatement of income¹⁰⁶ or an overstatement of a deduction¹⁰⁷ is strong evidence of negligence. Frequently, understatements of income are caused by omissions of specific items of income, such as unreported sales commissions, unreported income from medical services, dividends, interests, capital gains, and so on. Also, what constitutes an adequate explanation to rebut the presumption of negligence may range from mistaken interpretations of law and fact to good faith reliance on others.

(c) *Reliance on Others.* A taxpayer's reliance on others for advice, for the keeping of records, or in the preparation of returns, is another prolific area where the negligence penalty may arise. As a general rule, the taxpayer has the ultimate responsibility for errors in a return although he may have employed another to prepare the same.¹⁰⁸ However, the penalty may not apply if the taxpayer did in fact rely,¹⁰⁹ in good faith,¹¹⁰

Boynton v. Pedvick, 228 F.2d 745 (2d Cir. 1955). Penalty was imposed when taxpayer did not follow advice of accountant.

104. I.R.C. § 6001; Treas. Reg. § 1.6001-1(b).

105. Charles W. Williams, [1954] TAX CT. MEM. DEC. (CCH) 199. The failure to keep accounting records sufficiently accurate for income tax purposes may constitute negligence. See also, Rainwater, 23 T.C. 450 (1954), where bookkeeping methods did not retain records of daily receipts but kept adequate daily summaries of carbon copies of betting tickets, the penalty was not imposed.

106. Marcello v. Comm'r, 380 F.2d 509 (5th Cir. 1967).

107. Poletti v. Comm'r, 330 F.2d 818 (8th Cir. 1964).

108. Pohlen v. Comm'r, 165 F.2d 258 (5th Cir. 1948).

109. Golden Nugget, Inc., [1969] TAX CT. MEM. DEC. (CCH) 149.

110. Tatem Woffard, 5 T.C. 1152 (1945). No penalty where the omission was a result of good faith mistaken belief as to the legal effect of an assignment. See also Carmack v. Comm'r, 183 F.2d 1 (5th Cir. 1950). Penalty was imposed when taxpayer alleged in good faith he was unaware he had to report poker winnings.

upon the advice of a qualified counsel or accountant,¹¹¹ making full disclosure of all relevant facts to the same.¹¹² Nonetheless, an adverse finding may result if the expert tax advice was in conflict with known rules and regulations.¹¹³

(d) *Intentional Disregard of Rules and Regulations.* A 5% penalty is imposed not only for negligence, but for intentional disregard of the rules and regulations. Before the "intentional disregard" language was added to the statute, the Regulations declared that the negligence penalty would in fact apply if a taxpayer computed his tax in disregard of the instructions on the tax return.¹¹⁴ Subsequently, it was held that the penalty would *not* apply when a taxpayer computed his tax, disregarding the Regulations, provided he made full disclosure of his method of computation.¹¹⁵ Hence, the reason for the enactment of the "intentional disregard" language was to expressly prohibit such cases.

Nevertheless, the Tax Court has held, notwithstanding the enactment of the "intentional disregard" language to the statute, that the penalty will not apply to a taxpayer for having intentionally disregarded the rules and regulations provided he makes full disclosure in good faith.¹¹⁶ The penalty has been imposed, however, where good faith is lacking, as in such cases where the taxpayer repeatedly took large deductions for personal expenses,¹¹⁷ took large unsubstantiated deductions,¹¹⁸ claimed deductions known from a previous audit not to be deductible,¹¹⁹ or reported no income on grounds that tax was unconstitutional.¹²⁰

(4) Recommendations by the Conference

111. *Brown v. Comm'r*, 398 F.2d 832 (5th Cir. 1968). No penalty was assessed when airline pilots failed to report strike benefits on attorney's advice.

112. *Davis Regulator Co.*, 36 B.T.A. 437 (1937); *Pullman Inc.*, 8 T.C. 292 (1947). Penalty was not imposed when taxpayer omitted receipt of income due to a bona fide belief it was not taxable. However, sufficient information was found in balance sheet attached to his return to notify the I.R.S. of the transaction.

113. *Journal Co.*, 46 B.T.A. 841 (1942). Penalty was imposed when taxpayer relied on counsel's advice not to follow rules and regulations.

114. A.R.M. 23 C.B. 2, 231 (1920).

115. A.R.M. 105 C.B. 4, 322 (1921).

116. *Wesley Heat Trucking Co.*, 30 T.C. 10 (1958). Penalty was not imposed where sufficient information was disclosed in the return to inform the Commissioner of the nature of deductions taken by taxpayer in the honest belief that they were proper.

117. *McKissock*, [1969] TAX CT. MEM. DEC. (CCH) 105.

118. *Tomsykoski*, [1974] TAX CT. MEM. DEC. (CCH) 105.

119. *Drew*, [1972] TAX CT. MEM. DEC. (CCH) 40.

120. *Lamb*, [1973] TAX CT. MEM. DEC. (CCH) 71.

The Conference adopted the following recommendations in order to achieve greater fairness and effectiveness when applying the negligence penalty.

(a) *Recommendation 75-7(b)(1)(i), 75-7(b)(1)(ii), 75(b)(2), 75(b)(3)*. The Conference recommends retention of the negligence penalty with the corresponding burden of proof by a preponderance of the evidence falling upon the taxpayer. Moreover, negligence would be redefined to mean "failure to exercise reasonable care in keeping records or in preparing the tax return." The Conference also recommends that the present 5% penalty for intentional disregard of rules and regulations, but without intent to defraud, be repealed.

The Conference's rationale for retention of the 5% negligence penalty is that, if the current 5% rate is increased in order to deter further unintentional conduct, the effect would be *de minimis*.¹²¹ Since simple negligence as opposed to intentional crimes is less blameworthy and less in need of rehabilitation, it is less likely to be deterred by threat of punishment. Adoption of a definition of negligence in the statute itself is probably based on the contention that, since the present statute and Regulations lack such a definition, the inclusion of one would provide greater clarity when its imposition is being considered. Furthermore, the deletion of the "intentional disregard" language contained in the present statute is based upon the belief that it is

. . . confusing and superfluous. If it is designed to penalize taxpayers who decline to follow a disputed regulation, the penalty is inappropriate and should be repealed. When there is a bona fide dispute of law—over the validity of a regulation . . . the taxpayer should be allowed to assert his position without penalty and without conspicuously reflagging the item.¹²²

In response to these recommendations, the Service did not agree.

The concept of negligence, however subjective or amorphous it may appear to be, is well developed in legal practice and judicial precedent. For this reason, the Service would prefer to see no change in the current definition of 'negligence'.¹²³

In concurring with the Conference's recommendation, the Service should adopt said recommendation notwithstanding

121. See note 80, *supra* at 652.

122. *Id.* at 658.

123. See note 81, *supra*.

their assertion that "the concept of negligence . . . is well developed" judicially. First, it is disputable whether negligence is judicially well defined. Hence, the proposed legislative definition may add a degree of precision to the judicial definition. Second, assuming *arguendo* that negligence is judicially well defined, the proposed legislative definition of negligence conforms to the general judicial standard of "lack of reasonable care." It is conceded that to attempt a more precise definition of negligence would probably create more problems that it would solve. Adoption of the legislative definition will do no harm and possibly some good in terms of legislative and judicial clarity.

Furthermore, the "intentional disregard" language in the statute should be repealed. Implicit in the penalty itself is the assumption that the rules and regulations are invariably right and correctly interpret the statute. Obviously, this is not true. A taxpayer ought to be able to "disregard" a particular rule or regulation upon good faith and good reason. Moreover, he should be allowed to show his reasons for disregarding a regulation at any time, whether or not these reasons have been expressly stated on the return. If he intentionally disregards any rule or regulation without a reasonable basis for doing so, it would fall within the definition of negligence and thus invite the imposition of the penalty. Although there is case authority for the proposition that a taxpayer may rely in good faith upon expert tax advice when intentionally disregarding a rule or regulation for good reason, the judicial authority is weak and conflicting. Deletion of the "intentional disregard" language within the present statute would promote predictability and at the same time, further fairness and greater effectiveness.

(b) *Recommendation 75-7(b)(3)(i) and 75-7(b)(3)(ii)*. The Conference recommends that a new penalty be established for "reckless or intentional conduct (but without willful attempt to evade payment of tax)." The rate of this new ad valorem penalty would be fixed at some point between the 5% negligence penalty and the 50% civil fraud penalty, perhaps 25%. "Reckless conduct" would be defined as conscious disregard of the "substantial risk that an underpayment would occur." "Intentional conduct" would be defined as "meaning that in keeping records or preparing the tax return, the taxpayer knew that an underpayment would occur or was substantially certain to occur." Moreover, the taxpayer would have the burden to prove by a preponderance of evidence that his conduct was not reckless or intentional.

The Conference's purpose underlying this recommendation is to punish a certain type of misconduct which is something more than simple negligence and less than civil fraud.¹²⁴ This form of misconduct involves a mental attitude of "recklessness" and the current 5% negligence penalty is not a sufficient deterrent against such misconduct. However, there is no present penalty between the 5% negligence penalty and 50% civil fraud penalty, the latter penalty being reserved solely for blatantly culpable conduct. Consequently, an intermediate penalty for overstatement of deductions or understatement of income which is reckless or intentional but short of willful, would provide the necessary deterrent effect.

The Service responded to this particular recommendation in total opposition. Although they agreed that the 5% negligence penalty is not an adequate deterrent, it contended the establishment of a new intermediate penalty to make up for the shortcomings of the negligence penalty would do more harm than good.¹²⁵ No matter how "well-defined a new intermediate penalty might be, it can only complicate" the administrative burden to such an extent that the burdens would outweigh the benefits gained.

Such an approach . . . presents serious administrative problems. Which penalty to apply would have to be determined partially by the kind of conduct involved, and partially by whether that conduct accounted for a substantial portion of the underpayment. As a result, adoption of this recommendation would impose upon the examining agent the responsibility of determining which penalty should properly apply to each item of the deficiency. This in turn would lead to case by case inconsistencies in the application of penalty provisions.¹²⁶

In lieu of the Conference's proposal, the Service suggests that the rate of the negligence penalty be raised from 5% to 10%. The higher rate would have a greater deterrent value while increasing the Service's incentive in pursuing cases of negligence.

This writer concurs with the Service's position, that the Conference's recommendation in establishing a new inter-

124. See note 80 *supra* at 649-51.

125. See note 81 *supra*.

While the Service agrees that the 5 percent negligence penalty is not an adequate deterrent to non-compliance, a convincing case has not been made for a new intermediate level civil penalty as a better alternative to increasing the present negligence penalty.

126. See note 81 *supra*.

mediate penalty should not be adopted. It is difficult enough at present to determine whether various types of misconduct constitute criminal fraud, civil fraud, negligence, or none of the foregoing. Furthermore, there is probably a substantial lack of uniformity among the Service's personnel when applying various civil penalties. To interpose another gradation would merely complicate the administration of the tax laws and tend to add to the lack of uniformity. Essentially, the Conference's recommendation is to gradate degrees of negligence, short of willful evasion. Although it is theoretically meritorious, it is questionable whether it is administratively practical, especially in light of President Carter's interest in tax simplification.

However, if the intermediate penalty is adopted, the burden of proof should not fall on the taxpayer, but shift to the government to show by a preponderance of evidence that the taxpayer engaged in the prescribed conduct. Although the taxpayer possesses the facts of his alleged misconduct in his own mind, and therefore he is in a better position to rebut the presumption, the possibility of abuse of this penalty by the Service is substantial enough to warrant shifting the burden to the government. In this manner, the Service will assert the penalty only when they are reasonably certain of the facts involved.

C. The Civil Fraud Penalty

In the event there is an underpayment of tax due to fraud, a civil fraud penalty may be imposed based upon 50% of the total underpayment.¹²⁷ The imposition of the civil fraud penalty upon the underpaying taxpayer is the most drastic and severe of all the ad valorem penalties.

(1) Burden of Proof

The burden of persuasion in proving fraud is on the Commissioner,¹²⁸ and the standard of proof to be established is clear and convincing evidence, not a preponderance.¹²⁹ Seldom does the Commissioner have direct evidence of fraud, as in the case where a taxpayer admits to such. Absent such evidence, the underpaying taxpayer's state of mind must be proved by circumstantial evidence.¹³⁰

127. I.R.C. § 6653(b).

128. I.R.C. § 7454.

129. *M. Rea Gano*, 19 B.T.A. 518 (1930); *Hawkins v. Comm'r*, 234 F.2d 359 (6th Cir. 1956).

130. Day, *Trans.* [1965] TAX CT. MEM. DEC. (CCH) 326.

When a taxpayer *pleads nolo contendere* to a criminal fraud charge, the plea is not direct evidence concerning the civil fraud assessment,¹³¹ although it may be used for impeachment purposes.¹³² When a taxpayer *pleads guilty* to the same above, this is direct but not conclusive evidence concerning the civil fraud assessment.¹³³ However, a *conviction* for criminal fraud collaterally estops the taxpayer from denying the civil fraud assessment¹³⁴ for the same year. The conviction is deemed *res judicata* on the issue of civil fraud. The court will, nonetheless, review the conviction if it is "tainted" with improper acts of the trial court.¹³⁵ On the other hand, an acquittal from a criminal charge does not bar the Commissioner from assessing the civil fraud penalty. The criminal and civil aspects may therefore be determined under two differing standards of proof, e.g. beyond a reasonable doubt and clear and convincing evidence respectively.¹³⁶

It should be noted that although the burden of proof rests with the Commissioner as to civil fraud, the assessed underpayment is itself presumed to be correct until the taxpayer rebuts the presumption. If both parties fail because of inadequate proof on their respective issues, the underpayment will be sustained while the civil fraud penalty will be set aside.¹³⁷

Also, the Commissioner is not relieved of his burden of proof even though the taxpayer fails to appear at trial. Unless the Commissioner comes forth with satisfactory evidence, the civil fraud penalty will fail.¹³⁸

(2) Methods of Investigation

Ordinarily, fraud is discovered in the course of a revenue

131. B. Frank Wells, Jr., [1958] TAX CT. MEM. DEC. (CCH) 160.

132. Kilpatrick v. Comm'r, 227 F.2d 240 (5th Cir. 1955).

133. Bennett E. Mayers, 21 T.C. 331 (1953). The plea of guilty made in a criminal proceeding involving the same matter constitutes an admission against interest, and without any explanation of the circumstances surrounding the plea, is sufficient to establish fraud.

134. Thomas Worcester, Inc., [1965] TAX CT. MEM. DEC. (CCH) 199, *rev'd and vacated on this point*, Worcester v. Comm'r, 370 F.2d 713 (1st Cir. 1966), due to tainted evidence. *See also*, Tomlinson v. Lefkowitz, 334 F.2d 662 (5th Cir. 1964).

135. *Id.*

136. *See* note 21, *supra*.

137. Carter v. Campbell, 264 F.2d 930 (5th Cir. 1959).

138. Perez, [1974] TAX CT. MEM. DEC. (CCH) 211. Harold Delaney, [1958] TAX CT. MEM. DEC. (CCH) 185.

agent's examination of taxpayer's books and records while conducting a tax audit. However, if the taxpayer's books and records are unavailable because they were destroyed or are privileged, then the Commissioner may prove fraud in establishing an underpayment by various methods of reconstructing income and by locating specific sources of omitted income. Two basic methods of reconstructing income are set forth below but are not intended to be exhaustive.

(a) *Bank deposit method of proving underpayment.* Under this method, bank deposits are compared to reported income.¹³⁹ Large unexplained bank deposits may be treated as income in proving a fraudulent underpayment. A great discrepancy between large bank deposits and small reported gross income is evidence of fraudulent intent.¹⁴⁰ However, large unexplained bank deposits, standing alone, are generally insufficient to sustain the Commissioner's burden. The Commissioner must also prove a likely taxable source for the deposits.¹⁴¹ If the circumstances show that the deposits could only have a taxable source, the fraud penalty will be imposed.¹⁴² Also, the bank deposit method is used in criminal tax fraud cases but the standard of proof is a crucial factor since the burden of proof in a criminal case is much greater.

(b) *Net worth method of proving underpayment.* The net worth of a taxpayer at any particular time is the difference between his assets and liabilities on the date in question.¹⁴³ The increase in the taxpayers net worth at the close of the taxable year over his net worth at the beginning of the year is ascertained, and then compared to the taxpayer's reported income to determine whether there is a discrepancy. A discrepancy so found is evidence of fraudulent intent. However, the Commissioner must also prove a taxable source for the additional income¹⁴⁴ before the civil fraud penalty may be imposed. This particular accounting technique for determination of unreported income is the same whether civil fraud or criminal fraud is involved.¹⁴⁵ The chief difference is, again, the differing standard for burden of proof.

139. *Halle v. Comm'r*, 175 F.2d 500 (2d Cir. 1949).

140. *Puritan Church of America v. Comm'r*, 209 F.2d 306 (D.C. Cir. 1953).

141. *Armes v. Comm'r*, 448 F.2d 972 (5th Cir. 1971).

142. *Malone v. Comm'r*, 198 F.2d 851 (3d Cir. 1952).

143. *Kashat v. Comm'r*, 229 F.2d 282 (6th Cir. 1956).

144. *McKenzie*, [1974] TAX CT. MEM. DEC. (CCH) 1968.

145. *Kenney v. Comm'r*, 111 F.2d 374 (5th Cir. 1940).

(c) *Methods of investigation subject to judicial review.* The civil fraud penalty may not be avoided even though the Commissioner's method of investigation of the alleged fraud becomes overzealous, or possibly unethical. The Tax Court has no jurisdiction to inquire into the Commissioner's conduct.¹⁴⁶ However, when criminal penalties become involved, the Commissioner's method of investigation is subject to judicial review to afford the taxpayer his 4th Amendment protection against unreasonable searches and seizures and the 5th Amendment privilege against self incrimination. For example, the privilege against self incrimination does not apply to prevent civil fraud judgment, but it may possibly be invoked to prevent the Commissioner from obtaining information from the taxpayer in a civil fraud case if said information may be used against him in a criminal fraud case.

(3) Statute of Limitations

The normal statute of limitations for imposing ad valorem penalties is three years after the due date for filing.¹⁴⁷ However, this period may be extended to six years¹⁴⁸ after the return is filed when there is an understatement in excess of 25% of the amount of gross income stated in the return. When no return is filed, there is no statute of limitations.¹⁴⁹

Most importantly, where fraud is attributed to the underpayment, or a part thereof, there is no statute of limitations.¹⁵⁰ Thus, the civil fraud penalty may be imposed at any time upon the discovery of fraud. However, the fairness of this rule seems questionable, in light of cases where the rule becomes oppressive and causes extreme hardship. For example, the Commissioner was allowed to open up tax years dating back to World War II where a taxpayer claimed he paid out to suppliers in those particular years as much as he received in sales receipts.¹⁵¹

146. H.F. Kerr, 5 B.T.A. 1073 (1927).

147. I.R.C. § 6501.

148. *Id.*

149. *See* note 50, *supra*.

150. I.R.C. § 6501(c)(2); Homer L. Blackwell, [1961] TAX CT. MEM. DEC. (CCH) 124.

151. *Jackson v. Comm'r*, 380 F.2d 661 (6th Cir. 1967). *See also* *Lowry v.*

(4) Underpayment of Tax

Before the civil fraud penalty may be imposed, there must be an underpayment of tax. If there is no underpayment, there is no penalty notwithstanding the presence of fraudulent intent. The underpayment is the difference between the true tax liability and the amount due as reflected on the taxpayers original return.¹⁵² Amended returns,¹⁵³ delinquent returns,¹⁵⁴ or payments of tax after the original return is filed and while an audit is in progress¹⁵⁵ will not affect the operation of the civil fraud penalty. Furthermore, a net operating loss carryback will not affect the computation of an underpayment for a prior year, as opposed to a net operating loss carryforward.¹⁵⁶

One of the most criticized aspects of this penalty is that it applies to the total underpayment, even though only a small portion of said underpayment was due to fraud. For example, when a taxpayer in good faith and without fault, neither negligently or fraudulently fails to report specific items of income, and negligently fails to report other items of income, the entire underpayment is nonetheless subject to the civil fraud penalty if any part of it is tainted with fraud.¹⁵⁷

In light of the above, examining the underpayment is the first logical stage when contesting the imposition of the civil fraud penalty. When doing so, it is important to pay attention to both fraud tainted items and non fraud tainted items, such as depreciated allowances, business expenses, and similar deductions. Whatever item is eliminated from the underpayment, whether it be tainted with fraud or not, will reduce the amount of the penalty proportionately.

(5) Seeking a Definition of Civil Fraud

There is no specific statutory or judicial definition of civil fraud. It is not defined in the Code or the Regulations. Therefore, a cursory examination of several sources defining what constitutes fraud may prove helpful in seeking a definition of

Comm'r, 288 F.2d 517 (2d Cir. 1961), for a special case of hardship and inequity.

152. Aaron v. Hirschman, 12 T.C. 1223 (1949); Sam Broadhead, [1955] TAX CT. MEM. DEC. (CCH) 328, *aff'd*, 254 F.2d 169 (5th Cir. 1958).

153. Aaron v. Hirschman, 12 T.C. 1223 (1949).

154. Charles F. Bennett, 30 T.C. 114 (1958). Fraud was associated with deliberate failure to file a return in the first instance.

155. Bennie F. Stewart, 66 T.C. 54 (1976); Romm v. Comm'r, 245 F.2d 730 (4th Cir. 1957).

156. See notes 38 and 39, *supra*.

157. Johnson v. United States, 39 F. Supp. 103 (Ct. Cl. 1941).

such an elusive concept. Blacks Law Dictionary defines fraud in general as,

An intentional perversion of truth. . . . A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage. . . . 'Bad faith' and fraud is synonymous, and also synonyms of dishonesty, infidelity, faithlessness, perfidy, unfairness, etc.¹⁵⁸

Prosser's definition of the common law tort concept of fraud involves the following elements: a false material representation by defendant, with knowledge of its falsity or in *reckless disregard* of its veracity, with intent to induce plaintiff to act or not to act in reliance thereof, causing plaintiff to rely, resulting in injury.¹⁵⁹

Mertens definition of the statutory concept of civil fraud states that

The term 'fraud' means actual intentional wrong doing, and the intent required is the specific purpose to evade a tax believed to be owing. Fraud implies bad faith, intentional wrongdoing, and a sinister motive. It is never imputed or presumed. . . .¹⁶⁰

The Internal Revenue Manual defines this statutory concept of civil fraud as follows:

To successfully maintain a charge of fraud in a tax case, it is necessary to establish that a part of the deficiency is due to a false material representation of facts by the taxpayer and that he/she had knowledge of its falsity and intended that it be acted upon or accepted as the truth.¹⁶¹

By examining the above mentioned authorities, there emerges the essential element of fraud common to all, being the requisite state of mind of specific intent to deceive, or in the case of tax fraud, the specific intent to evade the tax. A closer examination of the above also illustrates that the Code distinguishes the common law tort concept of fraud by framing a slightly different statutory concept of civil tax fraud. This distinction involves the Code's deletion of the provision that "reckless disregard" is sufficient in and of itself to trigger the penalty. Thus, the statutory concept of civil tax fraud appears to require actual knowledge of the falsehood only, reckless disregard alone being insuf-

158. BLACK'S LAW DICTIONARY 788 (4th ed. 1968).

159. PROSSER, LAW OF TORTS 685-86 (4th ed. 1971).

160. MERTENS, LAW OF FEDERAL INCOME TAXATION 5510 (1976).

161. II CCH, INTERNAL REVENUE MANUAL-AUDIT, INTRODUCTION, § 4563.41 at 8177-8 (1977).

ficient. However, as the cases indicate, this is not necessarily true, reckless disregard may constitute fraud.

It can be safely said that what constitutes fraud is again a question of fact. However, there are certain "badges of fraud"¹⁶² which frequently arise when the fraud penalty is imposed. They are aptly set forth in the following quote from the United States Supreme Court.

By way of illustration, and not by way of limitation, we would think affirmative wilful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax-evasion motive plays any part in such conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime.¹⁶³

There are two common factual situations, although not exhaustive, where fraud may be found. One situation involves intentional failure to file any tax return whatsoever, in contrast to delinquency, while the other involves the filing of an intentional false tax return, in contrast to negligence.

(a) *Civil Fraud and Delinquency Compared.* As noted in above, the delinquency penalty is imposed for failure to file. The fact of failing to file, however, may also trigger the civil fraud penalty provided the necessary mental attitude of specific intent is present. Simple failure to file, absent the requisite state of mind is insufficient to establish fraud. When failure to file is coupled with other factors indicating the specific intent to do the same, fraud may then be established. Examples of such factors include taxpayers lying to revenue agents,¹⁶⁴ offering no explanation concerning his failure to file,¹⁶⁵ sophistication in terms of education or business experience,¹⁶⁶ concealment of income,¹⁶⁷ consistent failure to file,¹⁶⁸ and so forth.

162. Mornoff, [1955] TAX CT. MEM. DEC. (CCH) 243; Ben H. Logan, [1976] TAX CT. MEM. DEC. (CCH) 143. One of the so-called "badges of fraud", lack of cooperation with revenue agents, is to be ignored when a potential for criminal proceedings pervades the civil investigation.

163. *Spies v. United States*, 317 U.S. 492, 499 (1943).

164. Kubik, Trans., [1974] TAX CT. MEM. DEC. (CCH) 62; Broyhill, [1968] TAX. CT. MEM. DEC. (CCH) 25.

165. Robinson, [1968] TAX CT. MEM. DEC. (CCH) 28.

166. Klebanoff, [1973] TAX CT. MEM. DEC. (CCH) 174.

167. *Jones v. Comm'r*, 259 F.2d 300 (5th Cir. 1958). Failure to file is not enough to establish fraud. The taxpayer kept accurate books and records; no attempt to conceal income was indicated since he fully cooperated with revenue agents.

168. Richard Law, 2 T.C. 623 (1943).

It is important to take special note of the existing conflict between circuits concerning the question of what constitutes specific intent to evade tax. For example, the Eighth Circuit suggests that intentional failure to file in the absence of affirmative acts of fraud will not sustain the penalty.¹⁶⁹ Conversely, the Fourth Circuit refuses to hold to the above and asserts that intentional failure to file, notwithstanding the absence of affirmative acts of fraud, may sustain the civil fraud penalty provided "bad faith" or "intentional wrongdoing" is present.¹⁷⁰

(b) *Civil Fraud and Negligence Compared.* As stated previously, the negligence penalty is imposed for filing false tax returns negligently prepared. Nonetheless, when a falsely prepared tax return is coupled with the necessary mental attitude of specific intent to do the same, the civil fraud penalty will be imposed. Simple negligence alone is insufficient to establish fraud.¹⁷¹

When negligence becomes reckless, when tax returns are made in reckless disregard of their veracity, the issue of whether it is negligence or fraud becomes more complicated. This is not a clear area of the law. Although the code impliedly requires actual knowledge of falsehood, there is case authority to support the proposition that tax returns prepared or statements made in reckless disregard of their veracity may be sufficient to infer fraud.¹⁷²

Factors which may determine the outcome of this controversial issue include, whether the Commissioner can carry his burden of persuasion to the standard of clear and convincing proof, whether a taxpayer's books and records were so grossly inadequate as to indicate specific intent, whether understatements of deductions were so blatant as to overwhelm the plausibility of

169. *First Trust and Savings Bank of Davenport, Iowa v. United States*, 206 F.2d 97 (8th Cir. 1953). The taxpayer never filed an income tax return and there was no other "badge of fraud" except the taxpayer believed he had no taxable income and therefore no tax due and owing.

170. *Powell v. Granquist*, 252 F.2d 56 (9th Cir. 1958). A penalty was imposed when the taxpayer's failure to file resulted from his disapproval of the way the government was run in addition to his conviction against paying taxes.

171. *Mitchell v. Comm'r*, 118 F.2d 308 (5th Cir. 1941). Negligence, slight or great, is not enough to establish fraud.

172. *White v. United States*, 20 F. Supp. 623 (W.D. Ky. 1937).

negligence, and whether a taxpayer's defense of reliance on another party was in fact made in good faith.

The Board of Tax Appeals provided a very good summation of what the court requires when construing reckless negligence to be tantamount to fraud.

Isolated instances of discrepancy or occasional lapses from the rigid accountability contemplated by the law might conceivably be overlooked, but where the whole fabric of petitioner's tax accounting is permeated with gross error, where elaborate artifice is employed to accomplish the ends sought, where the evidence adduced in explanation on different occasions varies so as to make it all unreliable, where sworn statements are proven by records to be false, and where the errors both of law and of fact all tend to accomplish a reduction of apparent tax liability, the situation goes beyond mere fortuitous coincidence, or unintentional error. It evidences a purpose to evade.¹⁷³

(6) The Conference's Recommendation

The Conference also recommends an important change for the improvement of the civil fraud penalty.

(a) *Recommendation 75-7(b)(4)*. The Conference recommends that the present civil fraud penalty be redefined to apply only to the "willful attempt to evade payment of tax," and that this "should be understood to have the same meaning as Section 7201 of the Internal Revenue Code," the criminal tax evasion section. The reason for expressly equating the civil fraud section to that of the criminal fraud section, notwithstanding the difference in burden of proof, is to avoid definitional ambiguity.

Although the Service rejected this recommendation, it should nonetheless be fully adopted and the corresponding Code section amended. Except for the burden of proof, there is little difference between willful evasion under criminal tax fraud or under civil tax fraud. Evidence of this close relationship is reflected by the fact that conviction for criminal tax fraud operates as a collateral estoppel against a taxpayer's denial of civil tax fraud.¹⁷⁴ Also, the United States Supreme Court held that the term "willful" has essentially the same meaning in the misdemeanor section of the tax laws as in the felony sections.¹⁷⁵ Although the term is not used in the civil fraud sections, willfulness i.e. specific intent to evade, is as much a crucial element of the civil penalty as it is for a criminal offense. Thus, a uniform meaning of tax fraud, applicable to criminal and civil tax sections alike, would provide greater definitional accuracy and

173. M. Rea Gano, 19 B.T.A. 518, 533 (1930).

174. Lefkowitz v. Tomlinson, 334 F.2d 262 (5th Cir. 1964).

175. United States v. Bishop, 412 U.S. 346 (1973).

precision should the proposed definition be enacted.

(b) *Recommendation 75-7 (b)(5)*. The Conference recommends that when imposing penalties for underpayment of taxes, "each penalty rate should be applied only to the portion of the total underpayment that is attributable to conduct liable for penalty at such rate." In other words, the penalty would only attach to that portion of the underpayment tainted by the misconduct, fraud or negligence. As stated above, both the civil fraud penalty and the negligence penalty currently apply to the total underpayment when either fraud or negligence taints any part of said underpayment.¹⁷⁶

Although the Service rejected this recommendation for the reason that implementing such a policy would impose too great an administrative burden, the Conference's recommendation should be accepted because it seeks to conform tax penalties with basic principles of fairness and equity. Under current law, factual situations concerning underpayments arise leading to severe and oppressive results when a relatively small portion of the total underpayment is due to fraud or negligence.¹⁷⁷ It seems only reasonable, not to mention fair, that these respective penalties should attach only upon that part of the underpayment attributable to it, and not to that portion of the underpayment completely unrelated to fraud or negligence.

It should be noted that the Conference's recommendations do not suggest changing the rates for civil fraud or negligence. It is questionable whether the 5% negligence penalty applying to that portion of the underpayment tainted with negligence will

176. *Example I*. Corporation A and Corporation B each report taxable income of \$300,000. Upon audit it is determined that Corporation A has additional income of \$250,000, of which \$50,000 is attributable to fraud, and that Corporation B has \$50,000 of additional income all of which is attributable to fraud.

A. Under current law, Corporation A would owe additional tax of \$120,000 (48% of \$250,000), plus a fraud penalty of \$60,000 (50% of \$120,000). Corporation B would owe additional tax of \$24,000, plus a fraud penalty of \$12,000 (50% of \$24,000). The fraud penalty asserted against Corporation A would thus be five times as great as the fraud penalty asserted against Corporation B, although the fraud-tainted items of both are in the same amount.

B. Under the Conference's proposed change, the fraud penalty applied on both corporations would be limited to \$12,000 (i.e. 50% of the deficiency attributable to the fraud-tainted items).

177. *Johnson v. United States*, 39 F. Supp. 103 (Ct. Cl. 1941).

provide sufficient deterrence against such misconduct. If the Conference's recommendation is enacted, it may be necessary to raise the negligence penalty, perhaps 10% in order to provide an effective deterrent effect. Otherwise, it may be prudent to reject the recommendation as it applies to the negligence penalty.

Concerning civil fraud, the recommendation should be adopted without reservation. Not only is the rate, 50% stiff enough to satisfy the deterrence aspect, but there is also the additional deterrent of possible criminal prosecution.

While recommending that the civil fraud and negligence penalties should apply only to the underpayments attributable to each of them respectively, the Conference does not indicate how the penalty will be computed. One such method of computation is suggested as follows. Where the fraud penalty is involved, the penalty would be computed on the difference between the total underpayment, and the underpayment computed by excluding the fraud tainted items. This would result in the fraud penalty being asserted at the highest applicable tax bracket. If the negligence penalty is involved, the same method would apply. Where "non tainted" items, fraud tainted items, and negligence tainted items are all involved, the same computation would apply.¹⁷⁸

178. *Example II.* Computation of fraud penalty under Conference's proposed change to provide for penalty being computed at taxpayer's highest bracket.

Assume a joint tax return reflecting \$50,000 of taxable income, corrected income of \$60,000, and that \$4,000 of the additional \$10,000 of income is attributable to fraud.

A. The penalty would be computed on the difference between (1) total underpayment, and (2) underpayment computed by excluding the fraud-tainted items, thus:

Tax on corrected income of \$60,000 (53% bracket)	\$22,300	
Tax on \$50,000 per return	17,060	
Total underpayment.....		\$ 5,240
Tax on \$56,000 (corrected income of \$60,000 less \$4,000 fraud-tainted items)	\$20,180	
Tax on \$50,000 per return	17,060	
Underpayment excluding fraud-tainted item		\$ 3,120
Underpayment attributable to fraud-tainted item		\$ 2,120
Fraud penalty on \$2,120 at 50%.....		\$ 1,060
<i>Check:</i> 53% of \$4,000 equals \$2,120 of additional tax attributable to this item. 50% fraud penalty		\$ 1,060

Another computational problem arises concerning the definition of "underpayment" when fraud or negligence is attributable to a delinquent tax return, the failure to file situation. Under current law, the entire tax and not merely the deficiency is treated as the underpayment.¹⁷⁹ Consequently, the 50% civil fraud or 5% negligence penalty is computed on the entire tax since it is deemed the underpayment. Also, it has been held that if the return is delinquent, no credit is allowed in computing the penalty for taxes withheld or payments of estimated tax.¹⁸⁰ This is especially unfair and may cause harsh and oppressive results when a respective penalty is applied to such a situation.

It should be noted that the Conference did not address itself to this issue. Nevertheless, the Conference or Service should redefine "underpayment" not only to include fraud or negligence tainted items, but also allow credit for withheld taxes or estimated tax payments made before the due date.¹⁸¹

(c) *Recommendation 75-7(c)*. The Conference recommends that the Service seek statutory instruction with respect to publicizing the imposition of the 50% civil fraud penalty.

Although the Service agreed to this recommendation and will

B. Under current law, penalty would be 50% of total underpayment of \$5,240, or \$2,620.

179. I.R.C. § 6653(c)(1); Treas. Reg. § 301.6653-1(c); 22 THE TAX LAW. 967 (Summer 1969).

180. *Cirillo v. Comm'r*, 314 F.2d 478 (3d Cir. 1963); *Tomlinson v. Lefkowitz*, 334 F.2d 262 (5th Cir. 1964).

181. *Example III*. Assume the same facts as in Example II, except that return is filed late, and prior to due date of return the tax on \$50,000 (\$17,060) has been paid by withholding and estimated tax payments.

A. Under current law, the fraud penalty would be computed as follows:

Tax on corrected income of \$60,000.....	\$22,300
Fraud penalty (no credit being allowed for withholding or estimated tax payments)	
50% x \$22,300	\$11,150

B. Under the Conference's proposed change, limiting the penalty to fraud-tainted items and allowing credit for withholding and estimated tax payments, the underpayment would be \$5,240 and the fraud penalty would be \$1,060, as in Example II.

C. Rejecting the Conference's proposed change, not limiting penalty to fraud-tainted items but allowing credit for withholding and estimated tax payments made before the due date of return in determining underpayment, the penalty would be 50% of \$5,240 or \$2,620.

“seek such statutory instruction¹⁸² it should not be adopted. The government’s policy of publicizing tax indictments would seem to be a sufficient *in terrorem* device. When a fraud case is docketed in the Tax Court, the proposed fraud penalty becomes a matter of public record and is often reported in the press. Moreover, the average citizen does not distinguish between criminal fraud and civil fraud. If the deterrent publicity of tax fraud indictments and docketed fraud cases does not restrain a taxpayer, the additional publicity attending the mere assertion of a fraud penalty will not do so. Many agents assert the penalty on relatively weak facts, and many cases are settled on the basis of a negligence penalty or no penalty. Even if a settlement involves payment of the fraud penalty, publicity of that fact is not justified. Such cases often involve many issues, and the taxpayer’s agreement to the penalty may simply be one way of “disposing” of the whole problem, without constituting an admission of fraud. In this manner, the recommendation is unsound, and could set a dangerous precedent for making inroads upon a taxpayer’s confidentiality.

IV. CONCLUSION

The delinquency, negligence, and civil fraud penalties all serve to deter the underpaying taxpayer from particular forms of misconduct. Such misconduct involves a particular state of mind, or lack thereof. For delinquency, the misconduct is simple failure to file a tax return. No particular mental attitude need be present to trigger this penalty. The failure itself is sufficient in the absence of reasonable cause. For negligence, the misconduct is failure to file a tax return or a falsely prepared timely filed tax return, coupled with the necessary mental attitude of neglect. For this penalty, the taxpayer has the burden to prove the essential element lacking, or in the alternative, due care present. For civil fraud, the misconduct is failure to file a tax return or a falsely prepared timely filed tax return, coupled with the necessary mental attitude of specific intent to evade the tax. The Commissioner has the burden to prove the essential element present. Consequently, it is possible to conceptualize the appropriate state of mind, or lack thereof, to correspond to a “sliding scale” in reference to its respective penalty. As the penalty shifts from delinquency through negligence to civil fraud, the requisite state of mind becomes stronger. Also, the burden of proof provides an interesting twist to the scale. Recklessness, falling in the area between negligence and civil fraud,

182. See note 81, *supra*.

is the source of the greatest difficulty in ascertaining the true state of mind, in order to impose the appropriate civil penalty.

In considering the above mentioned penalties and their respective consequences, a taxpayer should pay due heed to the risks involved in simple carelessness, negligent carelessness, or intentional carelessness by not complying with the principle that our federal revenue system is based upon the honor system of self enforcement.¹⁸³

ARTHUR A. GRAVES III

183. *Bukowski v. United States*, 136 F. Supp. 91, 96 (S.D. Tex. 1955).
Come the Ides of March a taxpayer in performing his duty as a citizen in assessing his own taxes may not close his eyes to facts with which he is confronted daily, and, on being called to account, escape the consequences by saying, 'I didn't take time to read it (the return) over.'

