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In this article, Sheppard analyzes two recent Tax Court cases to demonstrate how fraud might be easy to allege but difficult for the IRS to prove.

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I. Introduction

Taxpayers who engage in tax fraud face serious consequences that include steep penalties, endless assessment periods, prolonged trials, reputational damage, denial of insurance coverage, revocation of professional licenses, credit problems, and the inability to operate their businesses. Mere allegations of fraud by the IRS can trigger those types of damaging outcomes. Cynics, along with taxpayers targeted by the IRS, often argue that that is precisely the reason the IRS sometimes claims that fraud occurred in the first place. Fortunately for taxpayers, alleging fraud is relatively easy, but proving it can be difficult for the IRS. Two recent Tax Court cases demonstrate this reality.

II. Overview of Fraud Standards

The IRS must establish, by clear and convincing evidence, that there was a tax underpayment and that underpayment was attributable to fraud.[1] Timing is also important because fraudulent intent is determined either when a taxpayer signs a tax return with the idea of filing it or when the taxpayer actually files the return.[2] The IRS cannot prove fraud unless the requisite intent existed at one of those critical points, even if the taxpayer *later* learns that the earlier tax return was inaccurate.[3] Courts have repeatedly refused to uphold fraud penalties when post-filing events, such as contact by the IRS, triggered a taxpayer's awareness that a prior return was flawed.[4]

The Internal Revenue Manual describes the high standard that the IRS must meet to make fraud penalties stick, as follows:

> Civil fraud penalties will be asserted when there is clear and convincing evidence to prove that some part of the underpayment of tax was due to civil fraud. Such evidence must show the taxpayer's intent to evade tax which the taxpayer believed to be owing. Intent is distinguished from inadvertence, reliance on incorrect technical advice, honest difference of opinion, negligence, or carelessness.[5]

The IRS and courts consider various "badges of fraud," which include understatement of income, inadequate records, failure to file returns, implausible or inconsistent explanations,

[1] Section 7454(a); Tax Court Rule 142(b); section 6663.

[2] *Merritt v. Commissioner*, 301 F.2d 484, 487 (5th Cir. 1962); *Wilson v. Commissioner*, 76 T.C. 623 (1981); *Coleman v. Commissioner*, T.C. Memo. 1988-538.

[3] *Piekos v. Commissioner*, T.C. Memo. 1982-602; *Broadhead v. Commissioner*, T.C. Memo. 1955-328.

[4] *See, e.g., Comparato v. Commissioner*, T.C. Memo. 1993-52.

[5] Internal Revenue Manual section 20.1.5.12.2.

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fictitious transactions, concealment of assets or activities, failure to cooperate with tax authorities, engaging in illegal activities, dealing in cash, filing false documents, not making estimated tax payments, and engaging in a pattern of conduct designed to mislead.[6] The taxpayer's level of sophistication — both generally and specifically regarding tax matters — is another factor taken into account when determining whether fraud existed.[7]

III. Consequences of Fraudulent Behavior

Committing tax fraud leads to various consequences, three of which are addressed here.

First, when a taxpayer files a tax return that is later deemed fraudulent, the IRS can assert extreme penalties under section 6663. That provision authorizes the IRS to impose a sanction equal to 75 percent of the tax underpayment on the relevant return. For example, if a taxpayer files a Form 1040, "U.S. Individual Income Tax Return," and the IRS audits it and successfully assesses a federal income tax liability of $100,000, the taxpayer will owe $175,0000 in taxes and penalties, plus interest accruing on both items.[8]

Second, when a taxpayer fails to file a tax return, and the violation is attributable to fraud, section 6651 empowers the IRS to impose a penalty equal to 15 percent of the tax liability that the taxpayer should have reported on the unfiled return for each month it is late, with a maximum of 75 percent.[9]

Third, filing fraudulent returns allows the IRS additional time to audit. The IRS generally has three years from the date on which a taxpayer files a return to assess additional taxes and penalties related to that return.[10] The three-year period expands in some situations. For example, if a taxpayer files a "false or fraudulent return with the intent to evade tax," the IRS may assess at any time under section 6501.[11] In other words, there is no time limit for assessment in such situations.[12]

In summary, the IRS can assert a civil fraud penalty, reaching 75 percent of the taxes due, against taxpayers who file fraudulent returns, as well as those who do not file returns for fraudulent reasons. The former happens thanks to section 6663, while the latter derives from section 6651. Fraud by taxpayers also creates an unlimited assessment period for the IRS under section 6501. These fraud-related rules have been pivotal in the two recent Tax Court cases analyzed below.

IV. First Recent Fraud Loss for IRS

The first case analyzing tax fraud was *Mill Road 36 Henry*, which involved a conservation easement donation.[13]

A. Key Facts

The original landowner contributed undeveloped land to a partnership (Property Company). It had a carryover basis in the property of about $430,000. The property was located on the south side of Atlanta, in an area experiencing heavy commercial and residential growth. Property Company's only asset was the property itself, which it held for purposes of selling it to a developer. With this goal in mind, the initial managing member — who we will call Smith — conducted due diligence. He also secured a "concept plan" from an independent consulting firm, which contemplated development of an assisted-living facility on the property. The concept plan envisioned 677 units at the facility.

Property Company, through Smith, filed an application to develop an assisted-living facility. The county planning and zoning board then issued a conditional use evaluation report. It recommended approval by the zoning advisory

[6] *Meier v. Commissioner*, 91 T.C. 273 (1988). *See also Toushin v. Commissioner*, 223 F.3d 642 (7th Cir. 2000); *Bradford v. Commissioner*, 796 F.2d 303 (9th Cir. 1986); and *Hicks Co. v. Commissioner*, 56 T.C. 982 (1971).

[7] *Graves v. Commissioner*, T.C. Memo. 1994-616; *see also Gow v. Commissioner*, T.C. Memo. 2000-93.

[8] Section 6663; IRS Memorandum LB&I-09-1118-014 (Nov. 20, 2018).

[9] Section 6651(f); reg. section 301.6651-1.

[10] Section 6501(a).

[11] Section 6501(c)(1); reg. section 301.6501(c)-1.

[12] *Payne v. Commissioner*, 224 F.3d 415 (5th Cir. 2000), *supplemented by* T.C. Memo. 2001-231; *Neely v. Commissioner*, 116 T.C. 79 (2001).

[13] *Mill Road 36 Henry LLC v. Commissioner*, T.C. Memo. 2023-129. The names of some of the parties have been changed to avoid distracting readers. For an expanded analysis of this case, see Hale E. Sheppard, "Valuation Loss in Recent Easement Case Obscures Silver Linings," *Tax Notes Federal*, Dec. 4, 2023, p. 1741.

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board, subject to conditions. Leaving an application pending could negatively affect the county's overall development plan. The staff at the county planning and zoning board, therefore, asked Smith to withdraw his application after getting conditional approval, if he believed that actual development would not occur. Smith did so.

At the same time that he was working with Property Company, Smith was the owner or agent of at least 10 other partnerships. The only asset of each partnership was a separate tract of land in the same county. The pattern was the same: Smith obtained a concept plan for an assisted-living facility, filed an application with the county planning and zoning board, received conditional approval, and then withdrew the application. All 10 partnerships ultimately donated conservation easements, and all their values were grounded in the idea that their peak use would have been the construction of an assisted-living facility.

The investment company was formed in 2016 by a party we will call Jones. The investment company issued a private placement memorandum, aggregated capital from numerous individual partners, used $1 million of the funds to purchase a 97 percent ownership interest in Property Company in September 2016, and voted three months later to donate a conservation easement on most of the property.

Property Company hired an appraiser to determine the value of the conservation easement. He based his original appraisal on the incorrect understanding that the property had been approved for construction of an assisted-living facility with 677 units. The reality was that it had only obtained "conditional approval," after which the application had been withdrawn. Next, the appraiser used the sales-comparison approach, employing a price-per-unit theory instead of a price-per-acre one. He concluded that each unit in the potential assisted-living facility would be worth $13,500, a figure he then multiplied by 677 units. This product, minus certain expenses, yielded a before-easement value of about $9 million. Considering the optimal use for the property after donating the easement and making other necessary adjustments, the original appraisal concluded that the fair market value of the easement was about $8.9 million.

B. Filings and Fighting

Property Company filed a timely tax return for 2016 showing the easement transaction. It attached to the return the original appraisal, Form 8283, "Noncash Charitable Donation," and Form 8886, "Reportable Transaction Disclosure Statement."

The IRS then audited. It eventually took the position that Property Company should get a tax deduction of $0 and should pay a penalty equal to 40 percent of the resulting tax liability because of a "gross valuation misstatement." Property Company challenged the IRS by submitting a timely petition with the Tax Court. Litigation ensued, and the Tax Court issued its opinion in late 2023.

C. Decision About Fraud

The IRS argued that the fraud penalty was appropriate because Property Company, through Smith and Jones, supposedly "intended to evade a tax known or believed to be owing through an intent to mislead."[14]

In rejecting this position, the Tax Court first turned to the disclosures made by Property Company to the IRS regarding the easement donation. It explained that charitable tax deductions face a "robust regime" of reporting and substantiation obligations. These include attaching a qualified appraisal, Form 8283, and Form 8886 to the relevant tax return. The Tax Court noted that Property Company did precisely that, thereby revealing to the IRS the large disparity between the "very low basis" in the property and the "very high claimed value" of the easement. The Tax Court offered the following thoughts about the importance of disclosure:

> We do not see conduct meant . . . to "conceal" or "mislead." This is not an instance in which a taxpayer buried an improper deduction deep in his return, nor even a case where the taxpayer relegated his disclosure of an improper deduction on a self-composed attached statement, which no one at the IRS might ever understand or even see. Rather, the

[14] *Mill Road 36 Henry LLC*, T.C. Memo. 2023-129, at 58.

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> conservation easement transaction was fully disclosed, in exactly the manner designed by the [IRS] to reveal charitable contribution deductions based on overstated value . . . We think that [Property Company's] compliant reporting was starkly at odds with an intention to conceal.[15]

The IRS took another swing. This time, it suggested that Property Company engaged in fraud, despite fully complying with all its disclosure duties. The Tax Court shot down the IRS again, based on the following reasoning.

First, the IRS underscored that Smith and Jones used the same pattern in at least 10 other easement transactions during the same year. The IRS suggested that the repeated method shows that the inflated valuation by Property Company was fraudulent, not accidental. The Tax Court discarded that accusation swiftly, explaining that it "did not view the multiplicity of deals per se as a badge of fraud."

Second, the IRS argued that "deliberate overvaluation" constitutes evidence of fraud. The Tax Court identified flaws with that line of reasoning. For instance, the case cited by the IRS to support its position was inapplicable because it involved a scenario involving an overvaluation *and* a lack of disclosure by the taxpayer. The Tax Court explained that a specific penalty for serious overvaluations already exists; it is called the "gross valuation misstatement penalty," and it is equal to 40 percent of the tax liability. The Tax Court concluded that because Property Company's valuation was disclosed to the IRS and triggered a gross valuation misstatement penalty, the fraud penalty was inappropriate.

Third, the IRS urged the Tax Court to place serious significance on the reliance by Property Company on a valuation (that is, the original appraisal) that contained "false statements and fraudulent analysis." The Tax Court clarified the original appraisal had two main problems. It incorrectly assumed that final approval, instead of conditional approval, existed for constructing the assisted-living facility. Also, it valued the property by unit instead of by acre. The Tax Court recognized that those errors were negligent and "woefully at odds" with some valuation principles, but they did not rise to the level of fraud.

Fourth, the IRS claimed that some testimony at trial lacked credibility, which sufficed to demonstrate fraud. The Tax Court had little patience for the idea. It pointed out that most of the material facts were either stipulated before trial or largely undisputed, only two instances identified by the IRS actually involved testimony by Smith or Jones, and that testimony was "not especially significant to the issue of fraud," "not critical to the case," or "settled by reference to documents" admitted into evidence at trial.

Fifth, the IRS maintained that the donation lacked "bona fide business transactions." The Tax Court said that was nothing new; the IRS was simply recharacterizing its earlier argument, already rejected by the Tax Court, that Property Company was not a true partnership for federal tax purposes. The Tax Court repeated that "by definition, a charitable contribution lacks a profit motive, but that does not invalidate the contribution nor deprive the donor of his deduction, nor does it suggest fraud."

Sixth, the IRS suggested that the strategy by Smith and Jones of requesting that the trials for all 11 conservation easement donations that occurred in the same year take place in different cities, presumably with different judges, showed fraudulent intent. The IRS labeled this an effort to "obfuscate and conceal" the "contemporaneous [syndicated conservation easement] enterprise" involving subdivided land. The Tax Court did not find this site-selection strategy particularly troubling, largely because it had no chance of succeeding thanks to the mechanisms in place for identifying and coordinating related cases.[16]

V. Second Recent Fraud Loss for IRS

The second recent case involving allegations of fraud, *Simpson*, might have a greater impact.[17]

[15] *Id.* at 59.

[16] *Id.* at 63, footnote 38.

[17] *Simpson v. Commissioner*, T.C. Memo. 2024-85. There are various related or consolidated cases, including *Scenic Trust v. Commissioner*, T.C. Dkt. No. 17749-21; *Hoyal v. Commissioner*, T.C. Memo. 2024-84; and *Parducci v. Commissioner*, T.C. Memo. 2023-75.

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A. Key Facts

Dennis Simpson earned an undergraduate degree, served in the Navy for about a decade, later worked in the financial industry, and ultimately started a "subscription business." He operated that business, along with a partner, for about 25 years. The business involved several related entities, including Reality Kats LLC, Maximillian LLC, and Scenic Trust. The last entity, established with the help of a specialized attorney, was supposedly formed for purposes of asset protection. Several agreements were executed in connection with Scenic Trust, among them a trust agreement, private annuity agreement, and unit purchase agreement. There was a consulting agreement between Reality Kats and Maximillian, too.

The money flow in the subscription business was confusing. The Tax Court described it as a structure involving related entities providing services to each other, making payments for services, deducting offsetting expenses, having "money bounce from entity to entity," and resulting in a "convoluted movement of funds." Nevertheless, the Tax Court acknowledged that it was not a question of unreported income because each entity that received payments reported them as gross receipts, and Simpson likewise reported all wages he received.

The two taxpayers relevant at trial, Simpson and Scenic Trust, had different filing postures with the IRS. Simpson filed a timely Form 1040 for 2012, but never submitted a valid Form 1040 for 2013.[18] By contrast, Scenic Trust filed a timely Form 1041, "U.S. Income Tax Return for Estates and Trusts," for 2012 and 2013.

The IRS audited Simpson, Scenic Trust, and other entities and individuals affiliated with the subscription business. They provided the IRS "extensive records" during the audit. These consisted of organizational documents, QuickBooks files, general ledgers, balance sheets, bank records, receipts, and copies of earlier tax returns. They also handed over "altered and backdated documents" as well as multiple versions of documents "with very different terms." Those included the trust agreement, private annuity agreement, unit purchase agreement, and consulting agreement. The Tax Court observed that neither the taxpayers nor their representative informed the revenue agent during the audit that any documents were altered, backdated, or inconsistent.

B. Proposed Taxes and Penalties

The IRS finally issued notices of deficiency in 2021. That was many years *after* the normal three-year assessment periods for Simpson and Scenic Trust had expired for 2012 and 2013.

Regarding Simpson, the IRS asserted $7.2 million in taxes, and a civil fraud penalty under section 6663 of $5.4 million for 2012 because he filed a Form 1040. The IRS was forced to take a different legal stance for 2013 because Simpson did not file a valid Form 1040 for that year. Specifically, the IRS imposed $2.5 million in taxes and a fraudulent failure-to-file penalty under section 6651 of $1.4 million.

Turning to Scenic Trust, the IRS was able to propose taxes and civil fraud penalties under section 6663 for both years, because it always filed Forms 1041. The liabilities for Scenic Trust totaled about $13.6 million.

C. Major Positions of the IRS

The IRS argued that its notices of deficiency, which seem late at first glance, were still valid, and the related taxes and penalties were still sustainable, for the following reasons:

- The Form 1040 filed by Simpson for 2012 was fraudulent, so the assessment period remained open indefinitely under section 6501, he owes federal income taxes, and civil fraud penalties under section 6663 apply.
- The Forms 1041 filed by Scenic Trust for both 2012 and 2013 contained fraud, meaning that under section 6501 the IRS had no time limit on issuing its notice of deficiency, the tax deficiencies are accurate, and civil fraud penalties under section 6663 are warranted.
- Simpson never filed a valid Form 1040 for 2013, so the assessment period was still open under section 6501, he must pay the taxes,

[18] *Parducci*, T.C. Memo. 2023-75 (related case in which the Tax Court held, after a partial trial on only one issue, that Simpson did not file a valid Form 1040 for 2013 because he never signed it, and he never officially authorized his accountant to sign it for him).

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and he should be sanctioned under section 6651 for his fraudulent failure.

D. Fraud Analysis When Returns Were Filed

The Tax Court started, as readers would expect, by reciting the legal standard for fraud and identifying the common "badges." It then got down to business. The Tax Court explained that the IRS had managed to prove only two badges. First, the Tax Court agreed that Simpson lacked credibility during the trial because he tried to downplay his role in the subscription business, said that he had no knowledge about transactions entered into by entities that he controlled, and tried to portray himself as a victim who had been misled by his partner and others. The Tax Court said that his testimony was contrary to the pertinent documents and the testimony of other witnesses. Second, the Tax Court held that Simpson engaged in a pattern of conduct designed to mislead the IRS by presenting altered, backdated, or inconsistent documents, hiding behind confusing explanations, and attacking his business partner.

The Tax Court then explained how the IRS fell short. It stated that the IRS's main defect was that it improperly attempted to rely on just *one* type of conduct by Simpson to satisfy *several* badges of fraud. The Tax Court summarized the IRS's problem as follows:

> [The IRS] cites the altered documents as support for the existence of conduct described by several badges [of fraud]. Although we believe that the altered documents support a finding of intent to mislead, *we decline to use a single act or event to support multiple badges*. Therefore, we will address the altered documents only under this specific badge.

The Tax Court proceeded to plod through the other badges of fraud, holding that each was either favorable to Simpson or neutral. Of note, the Tax Court held that (1) there was no underreporting of income because — when all the returns for all the relevant individuals and entities were considered as a group — all income was disclosed, (2) some of Simpson's seemingly implausible or inconsistent explanations could be attributed to the fact that more than a decade had passed between the time the returns were filed and the trial was held, (3) failing to notify the revenue agent during the audit of one sale that was incorrectly reported on a return, alone, did not constitute failure to cooperate, and (4) having a "convoluted" flow of income between related entities does not equate to concealment, especially when all the income was reported to the IRS somewhere.

The Tax Court ultimately concluded that the IRS could not assess any taxes or fraud penalties related to the Form 1040 for Simpson for 2012, or related to the Forms 1041 for Scenic Trust for 2012 and 2013. In other words, the IRS missed its chance to collect about $26.2 million, plus interest. Why? Well, as the Tax Court explained, the IRS allowed the normal three-year assessment period to expire, and then it failed to prove fraud at trial:

> After considering the entire record, we conclude that the [IRS] has failed to provide clear and convincing evidence that [Simpson and Scenic Trust] filed fraudulent returns. While the [IRS] presented evidence potentially supporting a finding of fraud, specifically Simpson's lack of credibility and the existence of altered and backdated documents, those badges alone are not sufficient to establish fraudulent intent by clear and convincing evidence.

The IRS was left with one possibility: assessing and collecting federal income taxes, and fraudulent failure-to-file penalties under section 6651, from Simpson for 2013. Time was not a problem for the IRS here because Simpson never filed a valid Form 1040 for that year, so the assessment period never started running against the IRS. The Tax Court held that the income, originally reported by Reality Kats, should really belong to Simpson based on the assignment-of-income doctrine. Moreover, the Tax Court decided that some items of income, initially included on Forms 1041 submitted by Scenic Trust, should be rerouted to Simpson under the grantor trust rules.

E. Fraud Analysis When Returns Were Not Filed

The Tax Court then turned to whether the fraudulent failure-to-file penalty under section

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6651 applied to Simpson. In other words, the Tax Court had to decide whether the standard delinquency penalty capped at 25 percent of the tax liability for 2013 should apply, or whether the increased penalty of 75 percent for fraud was appropriate.

The Tax Court explained that the same legal standards apply to fraud allegations under both section 6663 (that is, fraud on returns filed with the IRS) and section 6651 (that is, fraud for unfiled returns). It then indicated that it would consider the normal badges of fraud. In doing so, the Tax Court turned to an earlier case, *Mohamed*, with similar facts.[19] That case involved a fraud charge against a taxpayer whose business partner, without authority, signed and submitted a tax return on behalf of the taxpayer.

The Tax Court held in *Mohamed* that the fraud penalty was improper because the IRS did not prove that the taxpayer instructed his business partner to file the return so that he could later disavow it if the IRS were to audit. Based on the reasoning in *Mohamed*, the Tax Court held that Simpson would have to pay the tax liability for 2013 and the normal penalties for late filing and late payment, but *not* the enhanced sanction for fraud. The Tax Court summarized its thinking as follows:

> As in *Mohamed*, a return was filed for Simpson's 2013 tax year, but it was not signed by him or someone authorized to sign on his behalf. And, as in *Mohamed*, nothing in the record establishes that Simpson had someone sign his 2013 return without official authorization so that if the [IRS] examined it, Simpson could later disavow it. The [IRS] has failed to establish that Simpson's failure to file his 2013 return was fraudulent. As a result, the addition to tax for failure to file applies, but not at the increased rate for fraudulent failure to file.

VI. Conclusion

IRS enforcement actions have intensified in various areas thanks to additional funding, more personnel, and fewer COVID-related impediments. Think conservation easements and employee retention credits. The IRS has frequently alleged that taxpayers engaged in fraud, thereby attempting to impose higher penalties, create longer assessment periods, conduct more profound audits, expand litigation and the related costs, and otherwise cause havoc for taxpayers.

This article demonstrates that the IRS recently has encountered trouble persuading the Tax Court that some types of wrongdoing constitute fraud. Will that trigger IRS restraint when it comes to alleging fraud in the future? Probably not. Therefore, taxpayers that find themselves under IRS scrutiny should study cases like *Mill Road 36 Henry LLC* and *Simpson* — or hire tax professionals who do. ■

[19] *Mohamed v. Commissioner*, T.C. Memo. 2013-255.

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