

ACTION ON DECISION

IRB No. 2011-52
December 27, 2011

Subject: William & Sharon Norris v. Commissioner, T.C.
Memo. 2011-161

Issue: Whether the Tax Court erred when, in evaluating evidence of fraud, it weighed each of eleven badges of fraud equally, tallied the number “for,” “against” or “neutral,” and concluded that the Service did not establish fraud because only four of those badges had been proven.

Discussion: The taxpayers, a husband and wife, operated a convenience store during the years at issue, 1996 and 1998. Throughout those years, the taxpayer-husband operated several illegal gambling machines in the convenience store. The taxpayer-husband pled guilty to a charge of evasion under I.R.C. § 7201 for 1998 and, as part of his plea, admitted to taking “affirmative acts in 1998 to evade tax by conducting his affairs in cash, destroying records, and by concealing petitioners’ true and correct income.” The Service later issued a notice of deficiency determining that the taxpayers failed to report both legal-source and illegal-source income for both taxable years, and that the resulting understatement was due to fraud pursuant to I.R.C. § 6663.

In an order entered March 16, 2010, the Tax Court granted respondent’s motion for partial summary judgment, finding that, under the doctrine of collateral estoppel, taxpayer-husband could not contest the fact that he intended to evade tax for tax year 1998 and, therefore, could not contest his liability for the tax or the fraud penalty for that year.

As to fraud, the Tax Court found that the Service failed to prove that either taxpayer had intended to evade tax in 1996. To reach that conclusion, the court examined evidence of the taxpayers’ fraudulent intent by analyzing the eleven “badges of fraud” outlined in Niedringhaus v. Commissioner, 99 T.C. 202, 211 (1992), and giving each equal weight. It tallied its findings, counting four badges in support of fraud, five against and two “neutral,” and on that basis held the evidence insufficient to establish an intent to defraud.

The Tax Court’s approach in evaluating the evidence employed an artificial and rigid system of scoring in place of a consideration of the taxpayer’s entire course of conduct as reflected in the entire record. See Niedringhaus, 99 T.C. at 210. The eleven factors identified in Niedringhaus are appropriate indicators of fraud, but the list is not comprehensive. Fraud may be inferred “from any conduct the likely effect of which would be to mislead or conceal.” Kosinski v. Commissioner, 541 F.3d 671, 679 (6th Cir. 2008). “[A]ny effort to catalogue a list of evidence that satisfies this standard would be doomed to incompleteness.” Id. The Tax Court, itself, has recognized other indicators of fraud, including signing false bank loan applications, Fuller v. Commissioner, T.C. Memo. 2007-62, the use of nominee accounts, Temple v. Commissioner, T.C. Memo. 2000-237, and filing frivolous proceedings to quash the Service’s summonses, Earl v. Commissioner, T.C. Memo. 1998-452.

The Tax Court’s decision to “weigh all the factors equally” was also error. Strong evidence of only a few factors can be enough to prove fraudulent intent. See, e.g., Cooley v. Commissioner, T.C. Memo. 2004-49 (finding sufficient evidence of fraudulent intent due to a pattern of substantial understatement of income and failure to keep adequate records, particularly given

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the education and experience of the taxpayer); Kosinski, 541 F.3d at 679-80 (citing five “telltale badges of fraud”).

The Service will continue to evaluate evidence of fraud by examining all relevant conduct of a taxpayer. The Service will follow the guidelines set forth in I.R.M. 25.1.2.3, which outline the variety of ways in which fraud may be proven. In cases before the Tax Court, the Service will continue to argue that a determination of fraud is based on the taxpayer’s entire course of conduct, giving each badge of fraud the weight appropriate to the particular case.

Recommendation: Nonacquiescence

/s/

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