

# TEB Phase III - Lesson 5

## Fraud

### Overview

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#### Introduction

The Internal Revenue Service (IRS) is committed to the promotion of voluntary compliance with tax laws and regulations by taxpayers. In support of this effort, the IRS will consider the appropriateness of the application of penalties and, when warranted, the prosecution of those responsible for criminal violations of the tax laws.

As a part of the IRS's overall commitment to foster voluntary compliance, Tax Exempt Bonds (TEB), a division of the Governmental Entities (GE) division of the Tax Exempt and Governmental Entities Division (TE/GE) of the IRS, considers identification and development of fraud to be a critical part of its program.

This lesson provides an overview of fraud, defines and details the elements of fraud, and outlines procedures that Examiners should follow when a case appears to be potentially fraudulent.

#### **National Fraud Program**

The National Fraud Program is a service-wide program within SB/SE. The National Fraud Program Office is responsible for coordinating the establishment of Service-wide fraud strategies, policies, and procedures to enhance enforcement of the tax law. It also provides Fraud Referral Program coordination for all IRS operating divisions to identify fraud, develop fraud cases, and reduce the cycle time of fraud cases.

The National Fraud Program maintains a website, accessible on the IRS Intranet, which is designed to provide technical information, contacts, links to related offices, and news about the Service's Fraud Program activities. The primary objective of the fraud program is to foster voluntary compliance through the recommendation of criminal prosecutions and/or civil penalties against taxpayers who evade the payment of taxes known to be due and owing.

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## Overview, Continued

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### Introduction (continued)

#### **Discovery of Fraud**

The discovery and development of fraud cases are a normal result of effective investigative techniques. Techniques employed by the Tax Exempt Bond function should be designed to disclose not only errors in accounting and application of tax law, but also irregularities that indicate the possibility of fraud. Generally, for fraud to be considered, the tax exempt bond examiner must show:

- An additional tax due and owing due to a deliberate intent to evade tax
  - The willful and material submission of false statements or false documents in connection with a tax-advantaged bond financing and/or return.
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### Objectives

After completing this lesson, you will be able to:

- Define fraud
  - Define the various legal terms relating to fraud
  - Define willfulness
  - Distinguish between civil and criminal fraud.
  - Identify IRM guidelines that apply to Tax Exempt Bonds
  - Identify indicators (badges) of fraud
  - Describe your role as an examiner in the identification and development of fraud
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## Defining Fraud and Other Related Terms

<b>Reference</b> 	TEB IRM 4.81.5.12, Fraud and IRC 6700 Procedures
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### Definition of Fraud

The Fraud Handbook is located in [IRM 25.1](#). Section 25.1.1.2 of the IRM provides the following definition of fraud:

- (1) Fraud is deception by misrepresentation of material facts, or silence when good faith requires expression, resulting in material damage to one who relies on it and has the right to rely on it. Simply stated, it is obtaining something of value from someone else through deceit.
- (2) Tax fraud is often defined as an intentional wrongdoing on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing. Tax fraud requires both:
  - A tax due and owing
  - Fraudulent intent

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### What Fraud is Not

Fraud cannot be a mistake or an accident, carelessness, or reliance on others.

Errors do not imply fraud. Errors may indicate an irregularity in taxpayer compliance. While an irregularity in taxpayer compliance may be an indicator of the possibility of fraud, a presumption of fraud cannot be based on an irregularity alone.

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## Defining Fraud and Other Related Terms, Continued

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### Fraud Related Legal Terms

An examiner must be familiar with the following legal terms in order to understand the requirements for proof of fraud:

Burden of Proof- the obligation to offer evidence that a court (judge or jury) could reasonably believe in support of a contention. In tax fraud cases, the burden of proof is on the Government.

Evidence - data presented to a judge or jury in proof of the facts in issue and which may include the testimony of witnesses, records, documents, or objects. Evidence is distinguished from proof in that the latter is the result or effect of evidence.

- a. Direct Evidence - evidence in the form of testimony from a witness who actually saw, heard, or touched the subject of questioning. Direct evidence, which is believed, proves existence of fact in issue without inference or presumption.
- b. Circumstantial Evidence - evidence based on inference and not personal observation.
- c. Presumption (of law) - a rule of law that a judge or jury will draw a particular inference from a particular fact, or from particular evidence, unless and until the truth of such inference is disproved.
- d. Inference - a logical conclusion from given facts.
- e. Preponderance of evidence - evidence that will incline an impartial mind to one side rather than the other so as to remove the cause from the realm of speculation. It does not relate merely to the quantity of evidence. Simply stated, evidence which is more convincing than the evidence offered in opposition.
- f. Reasonable doubt - a doubt that would cause a prudent person to hesitate before acting in matters of importance to themselves. Such a doubt will leave a juror's mind uncertain after examination of the evidence.

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## Defining Fraud and Other Related Terms, Continued

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### Fraud Related Legal Terms

- g. Willful Intent to Defraud - an intentional wrongdoing with the specific purpose of evading a tax believed by the taxpayer to be owing.
  - h. Clear and Convincing Evidence - evidence showing that the thing to be proved is highly probable or reasonably certain. This is a greater burden of proof than preponderance of the evidence but less than beyond a reasonable doubt.
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### Willfulness

Probably the best place to start in understanding fraud is *Willfulness*.

Under § 7201, any person who willfully attempts in any manner to evade or defeat any tax imposed by Title 26 or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation) or imprisoned not more than 5 years, or both, together with the costs of prosecution.

Willfulness is a major factor in establishing fraud. Willfulness is an element of both civil and criminal fraud. The definition of willfulness has evolved from court decisions and is not defined by statute. Willfulness is a state of mind, a conscious, knowing decision to do or fail to do some act. It is defined as the "voluntary, intentional violation of a known legal duty." *Cheek v. United States*, 498 U.S. 192 (1991); *United States v. Pomponio*, 429 U.S. 10 (1976).

For a taxpayer to be guilty of a crime in which willfulness is an element, that individual must have acted deliberately, knowingly, and with specific intent to violate the law. A defendant's good faith belief that he is not violating the tax laws, no matter how objectively unreasonable that belief may be, is a defense in a tax prosecution.

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## Defining Fraud and Other Related Terms, Continued

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### Willfulness (continued)

Willfulness is composed of three factors:

1. **Knowledge** – Did he know the consequences of his act? Was he aware of the false statement or document? Was the submission or act deliberate? Was he aware of the indicated fraud? KNOWLEDGE may be shown by the taxpayer's actions.
2. **Intent** – Deliberate plan to evade is difficult to prove because it involves defining what is in the taxpayer's mind at the time he submitted the false document, statement, or return. INTENT can be implied from a taxpayer's actions.
3. **Purpose** – To show dishonest intention requires something more than the fact that the taxpayer acted intentionally or voluntarily. There must be an attempt to obscure the facts. This will be evidenced by a tax understatement. A dishonest purpose is closely related to indications of willful intent. Purpose should not be confused with motive. Motive is the reason for the act. The taxpayer must know the result of his act; he must believe that it will result in an illegal understatement of his tax liability. The taxpayer must intend to do the act, and his purpose must be to understate the tax liability.

Willfulness is not present where a taxpayer has acted by mistake, accidentally, or in good faith. Making an honest mistake is not a crime; deliberately choosing to not comply with the law can be. Mistakes, inadvertence, reliance on others, honest differences of opinion, and mere negligence or carelessness do NOT constitute willful intent.

Lack of willfulness is a valid defense to a charge of tax fraud. For example, not knowing that an individual was required to file a return, or believing that a return could not be filed without remittance, may constitute a defense in a failure to file case. Similarly, acting upon the professional advice of an attorney or CPA who had access to all relevant facts may constitute a defense of lack of willfulness in a case involving a questionable expense or deduction.

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## Civil and Criminal Fraud

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### Civil vs. Criminal Fraud

Understanding the requirements of proof is essential in establishing fraud. In all criminal and civil tax fraud cases, the burden of proof is on the government.

Civil fraud cases are remedial actions taken by the government such as assessing the correct tax and imposing civil penalties as an addition to tax, as well as retrieving transferred assets.

Criminal fraud cases are punitive actions with penalties consisting of fines and/or imprisonment.

Civil penalties are assessed and collected administratively as a part of the tax. The civil fraud penalty is recommended by the examiner in the audit report and may be applied with or without pursuit of criminal prosecution.

Criminal fraud results in a punitive action with penalties consisting of fines and/or imprisonment. Criminal penalties:

- Are enforced only by prosecution
- Are provided to punish the taxpayer for wrongdoings
- Serve as a deterrent to other taxpayers

The major difference between civil and criminal fraud is the degree of proof required, in:

- **Civil fraud** cases - the government must prove fraud by clear and convincing evidence.
- **Criminal** cases - the government must present sufficient evidence to prove guilt beyond a reasonable doubt.

Civil penalties are assessed and collected administratively as a part of the tax. The civil fraud penalty is recommended by the examiner in the audit report and may be applied with or without pursuit of criminal prosecution.

A tax fraud offense may result in both civil and criminal penalties. The normal 3-year statute of limitations does not apply if civil fraud can be sustained. If fraud is established, there is no statute of limitation for civil assessments, IRC § 6501(c)(1) and (2). The criminal statute of limitations is usually 6 years from the time the offense was committed (5 years in some cases).

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## Indicators of Fraud and Affirmative Acts of Fraud

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### Indicators (Badges) of Fraud

Signs of fraud are referred to as indicators or badges of fraud. Fraud indicators are an action, omission, or both. An action is defined as an activity deliberately undertaken in order to accomplish some objective. An omission is a failure to take action in a particular matter.

Taxpayers who knowingly take actions that result in the understatement of a tax liability often leave evidence in the form of identifying earmarks (or indicators). These indicators serve as a sign or symptom, or signify that actions *may* have been done for the purpose of deceit, concealment or to make things seem other than what they are.

Indicators may only suggest that actions may have occurred for the purpose of evading tax, however, indicators alone do not establish fraud.

The following can be indicators of fraud:

- Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks (or indicators).
- Serve as a sign or symptom, or signify that actions may have been done for the purpose of deceit, concealment or to make things seem other than what they are. Indications in and of themselves do not establish that a particular action was done.
- Examples include substantial unexplained increases in net worth, substantial excess of personal expenditures over available resources, bank deposits from unexplained sources substantially exceeding reported income, and documents that appear to be altered or false. Although the appearance of a suspicion is the first indication of a potential fraud, indicators alone do not establish fraud.

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## Indicators of Fraud and Affirmative Acts of Fraud, Continued

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### **Affirmative Acts of Fraud**

In order to establish fraud, the taxpayer must have committed some type of affirmative act of concealment or misrepresentation.

An affirmative act is a firm indicator that the taxpayer did or did not do something in order to evade or defeat tax. Affirmative acts establish the taxpayer's willful intent to evade payment of tax.

#### Affirmative acts of fraud are:

- Actions taken by the taxpayer, return preparer, promoter or other parties to a transaction with the intent to deceive or defraud. Fraud cannot be established without affirmative acts of fraud.
- Those actions that establish that a particular process *was* deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are.

Affirmative acts might be discovered by analyzing the substance of a transaction that is in reality something other than what it is purported to be based on a review of the relevant documents; i.e., a substance vs. form analysis.

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## Indicators of Fraud and Affirmative Acts of Fraud, Continued

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### **Indicators of Fraud vs. Affirmative Acts of Fraud**

As indicated previously, indicators of fraud alone are insufficient to prove fraud. The taxpayer must have committed some act to perpetrate the fraud.

Affirmative acts establish that the taxpayer committed certain actions with the specific purpose and willful intent of evading a tax liability. Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are.

Affirmative acts include:

- Deceit/Misrepresentation – For example, the submission of false or altered documents during the examination in an effort to establish compliance with laws or regulations.
- Concealment – Hiding during an examination the existence of bank accounts, brokerage accounts and other property or the existence of agreements and contracts that include parties to the transaction being examined is an example of concealment.
- Subterfuge – Maintaining two sets of books is an example of subterfuge on the part of the taxpayer.
- Camouflage – Diverting funds to transaction participants that would otherwise be payable to the U.S. Treasury and disguising such payments as transaction costs.

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## Indicators of Fraud and Affirmative Acts of Fraud, Continued

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**Tax Avoidance vs. Tax Evasion** Avoidance of tax is not an indicator of fraud. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and preplans events to reduce or eliminate tax liability within the perimeters of the law.

Tax evasion involves some affirmative act to evade or defeat a tax, or payment of tax.

Common evasion schemes include:

- Intentional understatement or omission of income
- Claiming fictitious or improper deductions
- False allocation of income
- Improper claims, credits, or exemptions

For fraudulent tax evasion, the burden of proof rests on the government. An examiner must establish a taxpayer's intent to defraud the government.

Tax fraud or an abusive transaction might not become apparent until after the initial interview is conducted and the books and records are examined; therefore, examiners should prepare workpapers and memoranda that sufficiently document potential indicators of fraud.

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## Role of the Examiner

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### **Your Role as Examiner**

The Director, TEB has designated a fraud coordinator to facilitate the development of fraud cases and to serve as a liaison between the National Fraud Program (NFP) and TEB. The TEB Fraud Coordinator (TEB FC), individually or in conjunction with the Fraud Technical Advisor (FTA) from SB/SE, will provide advice and/or guidance to the TEB managers and specialists on the development of fraud cases.

As soon as a TEB examiner discovers indicators of fraud, he/she should discuss the issue with the group manager. If the group manager concurs, the TEB examiner will contact the TEB FC to discuss the indicators of fraud. The TEB FC will contact a FTA if the case has fraud potential. If the FTA agrees, the TEB FC will arrange a 4-way conference call or meeting with the TEB examiner, group manager and FTA to discuss the case. If all parties agree that the case should be developed for fraud, the TEB examiner will complete Form 11661, *Fraud Development Recommendation - Examination*, and forward it to the TEB FC for signature.

IRM 25.1.2.2, *Fraud Development Procedures* includes additional fraud development procedures.

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## Resources

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### **Fraud Related Code and IRM Sections**

The following are relevant sections of the Code and IRM for purposes of fraud:

Title 26 USC §:

- 7201, Attempt to Evade or Defeat Tax
- 7202, Willful Failure to Collect or Pay over Tax
- 7203, Willful Failure to File Return, Supply Information, or Pay Tax
- 7204, Fraudulent Statement or Failure to Make Statement to Employees
- 7205, Fraudulent Withholding Exemption Certificate or Failure to Supply Information
- 7206, Fraud and False Statements
- 7207, Fraudulent Returns, Statements, or Other Documents
- 7211, False Statements to Purchasers or Lessees Relating to Tax
- 7212, Attempts to Interfere with Administration of Internal Revenue Laws

IRM §:

- 25.1 Fraud Handbook comprehensively addresses fraud and includes a section that specifically addresses fraud in Tax Exempt Bonds (see IRM 25.1.9.6)
  - 4.81.5.12 Fraud and IRC 6700 Procedures.
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## Summary

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### Review of Lesson 5

Fraud requires an intentional act and tax fraud requires that there be a tax due and owing. A mistake or error is not fraud.

It is important to be aware of the various fraud-related terms, including willfulness, which is a voluntary intentional violation of a known legal duty, and a requirement for the presence of fraud.

Signs or symptoms of fraud are indicators which might result from any affirmative acts committed by a taxpayer. Affirmative acts are firm indications of a taxpayer's intent to commit fraud and include among other things, deceit, subterfuge, camouflage, and concealment.

Avoidance of tax is not an indicator of fraud; however, tax evasion, which involves some affirmative act to evade or defeat a tax or payment of tax, is fraud.

Civil and criminal fraud requires different degrees of proof and the Government is required to establish the burden of proof for each. Criminal fraud requires that the strictest evidential standard of proof. Criminal fraud results in a punitive action with penalties consisting of fines and/or imprisonment.

In addition to the statutory regime of the Code and Regulations, the Internal Revenue Manual and Fraud Handbook are available to examiners to assist in the development of fraud.

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