

TAX COURT CASE UPDATE

Citation:

Frances Carlson v. United States, No. 12-13736 (11th Circuit), June 13, 2014.

Overview:

The Court of Appeals for the 11th Circuit, reversing a district court, has found that in order to impose the penalty under Code Section 6701 (the penalty for aiding and abetting the understatement of a tax liability), the IRS must prove fraud on the part of the return preparer. In deciding this, it split from the two circuits that had previously ruled on the issue.

The Facts:

The IRS imposed the Code Section 6701 penalty on Ms. Carlson, a tax preparer for the Jackson Hewitt tax preparation firm. Ms. Carlson brought suit in district court in opposition to this penalty. Over Ms. Carlson's objection, the district court instructed the jury that the IRS had the burden of proof by a preponderance of the evidence. Ms. Carlson contended that the correct standard of proof was by clear and convincing evidence and appealed to the 11th Circuit on that basis.

Discussion:

Code Section 6701(a) penalizes an individual:

(1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person.

The 11th Circuit and courts in the other circuits are in agreement that the IRS must prove fraud in civil tax cases by clear and convincing evidence. Two circuits have considered the question of what is the correct standard of proof under Code Section 6701. Both the Second and the Eighth Circuits have held that the correct standard of proof is by a preponderance of the evidence. In *Mattingly*, the Eighth Circuit acknowledged that the IRS must prove civil tax fraud by clear and convincing evidence, but held that this rule did not apply to Code Section 6701 because that code section does not require proof of fraud.

Conclusion:

The 11th Circuit held that Code Section 6701 requires proof of fraud, and therefore, under the *Ballard* rule, the standard of proof is "clear and convincing evidence." It thus split from the rule of the Second and Eighth Circuits.

The 11th Circuit said that, as other courts (including the Eighth Circuit in *Mattingly*) have recognized, the third element of Code Section 6701 requires the IRS to prove that the preparer acted with actual knowledge that the document would deprive the government of tax it is owed. Under this standard, the IRS must prove that the preparer actually knew the return understated tax. In other words, the IRS must prove that the preparer deceitfully prepared a return knowing it misrepresented or concealed something that understates the correct tax. This is a classic case of fraudulent conduct. The standard could be accurately paraphrased as requiring the IRS to prove that the preparer actually knew that the return defrauded the government of tax it is owed. The 11th Circuit then quoted a district court: "If the preparer knows that use of the tax document as prepared will result in an understatement of tax liability, must not the document necessarily be false or fraudulent?"

The IRS contended that Code Section 6701 cannot be a fraud statute because the statute never uses the word "fraud." However, the 11th Circuit said that the lack of the word "fraud" is immaterial if the conduct the IRS must prove meets the definition of fraud. And based on the foregoing analysis, it does. And, in other cases considering whether Code Section 6701 requires proof of fraud for determining the statute of limitations, the IRS has contended, and courts have agreed, that Code Section 6701 does require proof of fraud.

The 11th Circuit then went on to dispute the three reasons given by the Eighth Circuit in *Mattingly* for the latter's decision that Code Section 6701 does not require proof of fraud:

First, the Eighth Circuit concluded that Code Section 6701 does not require proof of fraud because it "does not refer to the evasion of tax." The 11th Circuit said that it is unclear why reference to the evasion of tax is relevant. The Eighth Circuit's prior precedent that fraud must be proven by clear and convincing evidence does not include this limitation. Neither does the 11th Circuit's precedent require reference to the evasion of tax. But, even if one was to assume that it is correct to require a statute to reference tax evasion, Code Section 6701 does reference tax evasion. Code Section 6701 requires actual knowledge that a return "would result in an understatement of the liability for tax of another person." Contrary to *Mattingly's* conclusion, Code Section 6701 exists to penalize tax preparers who design returns to evade tax.

Second, the *Mattingly* court concluded that "the integrated enactment of Code Sec. 6700-Code Sec. 6703 suggests application of a uniform standard of proof." The 11th Circuit said that it knew of no reason why statutes enacted at the same time must all use the same standard of proof. If anything, such a rule would likely lead to perverse results based on happenstance, instead of reason and precedent. And, even assuming laws enacted simultaneously must share the same standard of proof, the Eighth Circuit provided no reason why the correct standard is by a preponderance of the evidence and not by clear and convincing evidence. The legislation that created Code Sec. 6700-Code Sec. 6703 did not specify a standard of proof.

Finally, the Eighth Circuit concluded that the "the overall civil penalty structure applicable to taxpayers and tax preparers suggests that Code Section 6701 is just another piece in the expansive non-fraud penalty scheme." The 11th Circuit said that it agreed with the Eighth Circuit's recognition that the penalty structure is relevant, but it said that that structure suggests the opposite conclusion, in other words, that Code Section 6701 does require proof of fraud. There are three penalties in the Code that pertain to tax preparers: Code Section 6694(a), Code Section 6694(b) and Code Section 6701. Code Section 6694(b) penalizes tax preparers who understate the correct tax willfully or recklessly, even if the preparer does not actually know the return understates the correct tax. In contrast, Code Section 6701 requires actual knowledge

that the document understates tax. Actual knowledge is a higher standard than the "willfulness" standard utilized in other statutes. Whereas both Code Sections 6694(a) and 6694(b) penalties can apply when a tax preparer is negligent or reckless, Code Section 6701 requires proof that the tax preparer knew his or her conduct would defraud the government. This penalty structure indicates that Code Section 6701 is designed to require the highest level of culpability among the civil penalties for tax preparers.