

## Civil Tax Fraud

### Cross References

- *Abdul Khaliq Mustafa Muhammad, T.C. Memo. 2025-77*

IRC section 6663 imposes a civil fraud penalty with respect to a filed return if any part of any underpayment of tax required to be shown on the return is due to fraud. The amount of the penalty is 75% of the portion of the underpayment which is attributable to fraud. If any part of an underpayment is due to fraud, then the entire underpayment is treated as attributable to fraud, unless the taxpayer establishes that a portion of the underpayment is not attributable to fraud.

Fraud is an intentional wrongdoing designed to evade tax believed to be owing. The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Fraud is not to be presumed or based upon mere suspicion. But because direct proof of a taxpayer's intent is rarely available, fraudulent intent may be established by circumstantial evidence.

Courts often rely on various "badges" of fraud to find circumstantial evidence of fraud. These badges focus on whether the taxpayer engaged in certain conduct that is indicative of fraudulent intent, such as:

- Understating income,
- Failing to maintain adequate records,
- Offering implausible or inconsistent explanations,
- Concealing income or assets,
- Failing to cooperate with tax authorities,
- Engaging in illegal activities,
- Providing incomplete or misleading information to the taxpayer's tax return preparer,
- Offering false or incredible testimony,
- Filing false documents, including filing false income tax returns,
- Failing to file tax returns, and
- Engaging in extensive dealings in cash.

The existence of any one badge is not dispositive, but the existence of several badges is persuasive circumstantial evidence of fraud. The court also considers a taxpayer's intelligence, education, and tax expertise in determining whether he acted with the requisite fraudulent intent.

The taxpayer in this case is a management and program analyst with the IRS and holds multiple educational degrees including a master's degree in business administration and a Master of Science of Laws in International Taxation and Financial Services. The taxpayer has at least 31 years of government service.

The taxpayer operated a business, El Virtuoso Enterprise (EVE), providing education, finance, and insurance consulting services. The taxpayer filed timely tax returns which

included a Schedule C with respect to EVE. He reported net losses of \$36,515 and \$40,124 for 2017 and 2018, the years at issue. The taxpayer has reported Schedule C losses on every tax return he has filed since 2012.

The IRS selected the taxpayer's returns for examination and assigned a Revenue Agent (RA) to audit the taxpayer's returns. The RA conducted an in-person interview and subsequently toured the taxpayer's home and workspace.

The taxpayer claimed that he experienced computer damage at his home in 2017 and water damage in 2018 which led to a loss of alleged business records. The taxpayer made related claims with Verizon and Nationwide Insurance.

As the audit progressed, the taxpayer became nonresponsive and noncompliant. Shortly after the RA visited the taxpayer's home, the taxpayer filed a complaint against her alleging that she acted improperly by suggesting that he could pay the deficiencies by credit card and requested that the examination be terminated.

From the bank deposits analysis, the RA determined that the taxpayer had unreported Schedule C gross receipts for the years at issue. Because of lack of evidence and substantiation for EVE business deductions, the RA also disallowed claimed Schedule C deductions.

The RA made an initial determination to assert the civil fraud penalties under IRC section 6663 and, in the alternative, the negligence and substantial understatement penalties under IRC section 6662 for the years at issue.

The taxpayer timely filed a petition with the tax court seeking redetermination of the deficiencies and penalties. The court issued an opinion granting the IRS's motion for partial summary judgement on the issue of unreported income (*Muhammad*, T.C. Memo. 2023-124). The court ruled that the RA had properly employed a bank deposits analysis in determining unreported gross receipts for the years at issue.

The court also held that the parties could present additional evidence relating to the fraud penalties at a future trial.

At a subsequent trial, which is the subject of this case, the RA provided testimony regarding the audit and the allegations of improper conduct. The IRS then filed a supplemental memorandum brief. The taxpayer did not file a response.

The court considered the "badges" of fraud and stated the taxpayer substantially understated his income, failed to keep adequate records, offered implausible or inconsistent explanations, and failed to cooperate with tax authorities.

The court stated that as an IRS employee and holder of several degrees pertaining to taxation, he was aware of recordkeeping requirements. Upon request, he did not provide any business records related to EVE and maintained that such records were lost due to flood and computer damage. When invited by the court to testify, he repeatedly asserted he had no alternative substantiation and refused to even attempt to reconstruct any records.

The taxpayer also failed to provide plausible explanations as to his unreported gross receipts and lack of records. He asserted that the unreported gross receipts were attributable to an insurance payout and redeposited cash, but he did not provide any evidence in support of this claim.

While he did testify that all his records were lost as a result of flood and computer damage, he did not provide any testimony or information about the circumstances of the flood or computer damage. Although the court invited the taxpayer to present testimony to reconstruct unavailable records and explain the nature of his activities, he repeatedly declined to provide such testimony. While the taxpayer presented insurance claims he made regarding alleged flood and computer damage, these exhibits do not establish that flood or computer damage occurred. Neither do they provide any indication of causation, extent of damage, or the outcome of the claims. Rather, taken on their own, they substantiate only that the taxpayer made insurance claims.

The taxpayer also failed to communicate and cooperate with the IRS throughout the audit. Although the RA requested substantiating documents, the taxpayer did not provide any. As a result, the RA issued summonses to the taxpayer's banks in order to complete her bank deposits analysis.

At trial, the taxpayer made allegations concerning the RA's conduct during the examination. During the trial, the RA addressed the allegations of improper conduct and testified that she had suggested payment of the liability by credit card only as an option. There is no information in the record to suggest any action was taken as a result of the taxpayer's complaint against the RA. On the basis of the evidence presented, the tax court was satisfied that the RA did not engage in improper conduct. Further, the taxpayer's allegations do not explain why he failed to communicate and cooperate with the IRS during his audit.

On the basis of the circumstantial evidence considered by the tax court, the court stated that the taxpayer engaged in repeated underreporting of income, claimed numerous deductions and expenses beyond receipts, failed to keep adequate records, and failed to cooperate with tax authorities. Considering the taxpayer's background and his refusal to provide any testimony to reconstruct records, the existence of several badges of fraud in this matter is persuasive circumstantial evidence of fraud. The court was continually frustrated by the taxpayer's failure to provide adequate explanations despite having been provided opportunities to do so.

The court ruled that the IRS has established, by clear and convincing evidence, that the taxpayer's underpayments of tax for the tax years at issue were attributable to fraud and subject to the civil fraud penalties under IRC section 6663.