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# Avoiding the Sec. 7206(2) criminal penalty for false/fraudulent return preparation.

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*Author: Altieri, Mark P.*

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Sec. 7206(2), which punishes aiding or assisting in the preparation of a false or fraudulent return, carries a penalty of a fine, imprisonment, or both. According to the courts, a three-prong test applies in determining whether a defendant has violated that section. This article explores this test, the standards the courts use in applying it and ways to avoid Sec. 7206(2)s application.

Sec. 7206(2) provides that any person who

willfully aids or assists ill, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim or document ... shall be guilty of a felony.(1)

As is clear from the statute's language and as is detailed in the case law, a Sec. 7206(2) offense contains three elements: (1) the act of aiding or assisting, (2) material falsity and (3) willfulness.(2)

## Aiding or Assisting

According to Hooks,(3) to establish the first element, there must exist some affirmative participation that at least encourages the filer of the false return; the aider must knowingly participate in the venture with the intent to defraud the government. As stated in Hooks, "to aid and abet another to commit a crime it is necessary that a defendant in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, and that he seek by his action to make it succeed."(4)

Criminality under the statute is not limited to the direct tax preparer of the fraudulent return, but extends to any person participating in the fraudulent preparation in any material capacity. A variety of "indirect" activities have been found to constitute aiding and assisting; thus, Sec. 7206(2) is invoked if the aider assisted in the preparation or filing of a knowingly false return. As stated in Kelley,(5) the legislative intent behind the predecessor to Sec. 7206(2) was "to reach the advisers of taxpayers who ... might wish to keep down the taxes because of the credit they would get with their principals, who might be



altogether innocent."

Tax or legal advice that is clearly or arguably proper in might of established law, cannot constitute Sec. 7206(2) aiding or assisting.(6) The aiding or assisting must be directed toward the preparation or presentation of an intentionally false return; thus, proof that a defendant embezzled money from his employer corporation and falsified invoices to conceal the theft (but not specifically to falsify a tax return) was insufficient to sustain a determination that he willfully aided or assisted in the preparation or presentation of a false or fraudulent corporate return.(7)

### Material Falsity

The case law has established a relatively low evidentiary requirement for materiality in false return cases; a particular item is "material" if it must be reported for a taxpayer to estimate and compute his tax correctly.(8) Although the materiality standard seems fairly straightforward (and a low threshold for the government to meet), the Supreme Court recently added a procedural hurdle. In Gaudin,(9) the Court unanimously affirmed a Ninth Circuit opinion holding that the concept of materiality in any Federal perjury case (including a tax fraud case) is a question for the jury, not a question of law for the court.

### Willfulness

Although somewhat intertwined with the "aiding or assisting" criteria, the third requirement for the invocation of Sec. 7206(2) is willfulness on the aider's part in preparing or presenting the false or fraudulent return. Unlike the first requirement, the case law presents the prosecutor with a formidable evidentiary hurdle.

A number of tax crimes found in IRC Chapter 75, Crimes, Other Offenses and Forfeitures, have a willfulness element. The Supreme Court has determined that the willfulness element in

- \* Sec. 7201, Attempt to Evade or Defeat Tax;
- \* Sec. 7202, Willful Failure to Collect or Pay Overtax;
- \* Sec. 7203, Willful Failure to File Return, Supply Information, or Pay Tax; and
- \* Sec. 7207, Fraudulent Returns,

Statements or Other Documents, has the same meaning as the willfulness requirement in Sec. 7206.(10) As discussed below, the courts have stated that in an statutory tax crimes, "willfulness" requires a showing of specific intent to commit the illegal act that aids in or causes the creation and/or filing of a fraudulent return; more than a showing of careless disregard is required.(11)

This standard imposes a higher burden of proof on the prosecution than in most other criminal cases. Generally, in a criminal case, ignorance of the law is not a defense; the prosecution need only show that the defendant had the intent to commit the acts contributing to the offense. The prosecutor need not show that the defendant knew the acts were prohibited under the criminal laws or acted with an intent to violate them.



As noted in *Cheek*,<sup>(12)</sup> the general common-law rule for criminal cases has been significantly modified by Congress for Federal criminal tax offenses under the Code. The courts have applied the willfulness element to require a finding beyond a reasonable doubt that the defendant acted with the specific intent to violate the tax laws. Thus, good-faith ignorance of the law may be a defense in a tax case.

### The Cheek Case

John L. Cheek, an airline pilot, had been indoctrinated into a group that believed the Federal tax system was unconstitutional. He was charged with six counts of willfully failing to file a Federal income tax return in violation of Sec. 7203 and three counts of willfully attempting to evade income tax in violation of Sec. 7201. The Supreme Court noted that the tax offenses with which Cheek was charged were specific intent crimes that required him to have acted willfully.

The Court cited to its long-standing rule in *Murdock*<sup>(13)</sup> that "Congress did not intend that a person, by reason of a bona fide misunderstanding as to his liability for the tax, as to his duty to make a return, or as to the adequacy of the records he maintained, should become a criminal by his mere failure to measure up to the prescribed standard of conduct."

The Cheek Court went on to note other Supreme Court decisions refining the willfulness concept established in *Murdock*. In *Bishop*,<sup>(14)</sup> the Court described willfulness as requiring "a voluntary, intentional violation of a known legal duty." However, the Seventh Circuit, in *Buckner*,<sup>(15)</sup> added a critical distinction to the willfulness test by disregarding the defendant's subjective state of mind and requiring that his mistake of law be "objectively reasonable."

The Cheek Court resolved this conflict in favor of a subjective test for willfulness. The Court retreated from the showing of "evil purpose" required by the Bishop Court, and simply focused on the intentional violation of a known legal duty. The Cheek Court held that a good-faith misunderstanding of the law or a good-faith belief that one is not violating the law negates willfulness, whether or not the claimed belief or misunderstanding is objectively reasonable.<sup>(16)</sup>

### New Standard

Convictions under this willfulness standard bear out the wisdom of requiring a defendant's demonstrated intent to violate a known legal duty, thereby protecting citizens from prosecution for innocent mistakes and focusing the full force and effect of the law on true tax frauds. A review of the cases illustrates the type of subjective knowledge and demonstrated intent to assist in the filing of a knowingly false return that Sec. 7206(2) requires:

\* In *Kelley*,<sup>(17)</sup> the organizer and leader of a group, in exchange for dues from members, expounded the belief that the Federal income tax was unconstitutional as applied to wages, and provided forms and instructions on the preparation of knowingly false W-4 forms.

\* In *Nealy*,<sup>(18)</sup> the aider knowingly supplied false reports that greatly inflated the estimated



reserves in a coal tax shelter program. (Clearly fraudulent tax shelter promoters have been a frequent past target of Sec. 7206(2).)

\* In Orr,(19) the convicted aider was an apartment manager who assisted in the creation and filing of fictitious tax returns for prospective tenants.

\* In Martin,(20) the convicted aider was the organizer of a marketed tax protestor group who prepared false returns for "member/customers."

\* In Jerkins,(21) the convicted aider was an attorney who assisted his drug dealer client in preparing and filing false returns.

\* In Clardy,(22) the convicted aider assisted taxpayers in filing false income tax returns that claimed prepaid interest deductions to which they were not entitled. The defendant carried out a schedule of check swapping and kiting to pay the purported interest on supposed sales of land to said taxpayers.

### Avoiding Sec. 7206

The cases discussed amply demonstrate the egregious fact patterns that allow the government to successfully assert a Sec. 7206(2) violation. However, due to the severity of punishment for a convicted Sec. 7206 felon (fine and/or imprisonment), and to avoid any possibility of contending with the time, expense and stress of an overzealous Federal prosecutor, the tax adviser should not summarily dismiss Sec. 7206(2) as too remote a possibility to warrant concern. How can an encounter with Sec. 7206(2) be avoided?

Practitioners should recall the criteria (discussed below) applicable to the preparer penalties as a device to preempt a criminal fact pattern from developing.(23) Moreover, the tax adviser who is practicing within the AICPA's Statements on Responsibilities in Tax Practice(24) (SRTPs) should blunt civil or criminal problems.

### Understatement Due to an Unrealistic Position

Sec. 6694(a) and the regulations thereunder impose a \$250 penalty on a preparer for each understatement of tax due to an undisclosed position that had no realistic possibility, of being sustained on its merits. Regs. Sec. 1.6694-(2)(b)(1) defines the realistic possibility standard to mean a one in three, or greater, likelihood of being sustained.

### Willful or Reckless Understatement

Sec. 6694(b) increases the Sec. 6694(a) penalty to \$1,000 if the understatement is willful or reckless. Regs. Sec. 1.6694-3(b) states that a willful attempt to understate tax liability occurs if the preparer disregards, in an attempt to wrongfully reduce the taxpayer's tax liability, information furnished by the taxpayer or others. Regs. Sec. 1.6694-3(c)(1) states that the preparer is reckless (or has intentionally disregarded the rules or regulations) if he makes little or no effort to determine whether a reporting position is contrary to a published rule or regulation and such lack of effort is a substantial deviation from a reasonable tax preparer's standard of conduct.

### Aiding or Abetting Penalty



The Sec. 6701 penalty sanctions aiding or abetting in the preparation of a return or other document by any person who knew (or had reason to believe) that such return or other document would result in the understatement of tax liability. This section imposes a \$1,000 penalty (\$10,000 for an understated corporate return or other document). Sec. 6701 is intended to be the civil analogue to Sec. 7206(2)2-5; the critical difference is that the civil proceeding has a lower ("preponderance of the evidence") burden of proof. Unlike Sec. 7206(2), which has no lost revenue criterion, the civil penalty is expressly conditioned on the aider participating in an understatement of tax liability. Although the legislative history indicates that Congress did not intend to extend Sec. 6701 to advisers who took a reasonable reporting position, the case law has focused more on the knowledge-of-understatement criterion. The Eighth Circuit has noted that while actual knowledge is the correct standard under Sec. 6701, the requisite knowledge may be inferred from the preparer's "willful blindness" to the applicable tax law.(27)

### Ethical Guidelines

The SRTPs, particularly Statements No. 1, Tax Return Positions, and No. 8, Form and Content of Advice to Clients, provide more general guidelines to avoid a civil or criminal dilemma. Those SRTPs review the criteria for rendering advice that reflects professional competence and appropriately serves the client's needs, while assuring that the tax adviser has a good-faith belief that the position would have a realistic possibility of being sustained administratively or judicially on its merits if challenged.

### Conclusion

As evident from the summary of the preparer penalties, and the SRTPs, the adviser may readily assist a taxpayer in less-than-clear situations without having to vouch for the pro-taxpayer outcome of a tax contest. What is required is a professionally sound, good-faith belief that there would be a realistic possibility of success in the event of such a contest. Clearly, the government should be similarly ethically constrained not to impose a "chilling effect" by improperly threatening civil penalties on tax advisers who follow professionally accepted methodologies and promote legal tax avoidance.

With regard to criminal sanctions, although Sec. 7206(2), on its face, does not require a demonstrable "evil intent," as was discussed earlier, the government must show the defendant knowingly, willfully, and fraudulently acted with a specific intent to violate the tax laws.(28) Absent such a showing, the government should fail in its efforts to convict an alleged aider under Sec. 7206(2).

(1) A conviction is punishable by a fine of not more than \$100,000 \$500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

(2) See, e.g., John E. Crooks, 804 F2d 1441, 1448 (9th Cir. 1986), Karl L. Dahlstrom, 713 F2d 1423, 1426 (9th Cir. 1983)(52 AFTR2d 83-9836, 83-2 USTC [paragraph] 99557); Louis Joseph Salerno, 902 F2d 1429 (9th Cir. 1990)(65 AFTR2D 90-1136, 90-1 USTC [paragraph] 50,261), cert. denied.

(3) William R. Hooks, 848 F2d 785 (7th Cir. 1988); see also Robert B. Graham, 758 F2d



879 (3d Cir. 1985)(55 AFTR2d 85-1337, 85-1 USTC [paragraph] 9317).

(4) *Id.*, 848 F2d 789, citing *L. Hand, J.*, in *Joseph Peoni*, 100 F2d 401, 402 (2d Cir. 1938).

(5) *John M. Kelley*, 105 F2d 912, 917(2d Cir.1939); see also *J. Lacey Barnes* 313 F2d 325 (6th Cir. 1963)(11 AFTR2d 679, 63-1 USTC [paragraph] 9247) (attorney who counseled clients on illegal tax scheme); *Ronald J. Sassak*, 881 F2d 276 (6th Cir. 1989)(64 AFTR2d 89-5338,89-2 USTC [paragraph] 9455) (a typist who knowingly and willfully assisted fraudulently filing taxpayers); *Robert E. Iles*, 906 F2d 1122 (6th Cir. 1990) (66 AFTR2d 90-5303, 90-2 USTC [paragraph] 50,366) (a promoter who marketed knowingly fraudulent tax shelters); *Norman N. Wolfson*, 573 F2d 216 (5th Cir. 1978)(42 AFTR2d 78-5098, 78-1 USTC [paragraph] 9456) (an appraiser who provided false appraisals with the knowledge and expectation that they would be used to claim inflated charitable deductions).

(6) According to *Dahlstrom*, note 2, 713 F2d 1428, citing *Amy T Critzer*, 498 F2d 1160,1162 (4th Cir. 1974)(34 AFTR2D 74-5180, 74-2 USTC [paragraph] 9505), "It is settled that when the law ... is highly debatable, a defendant -- actually or imputedly -- lacks the requisite intent to violate it." Further, citing *Dorothy R. Garber*, 607 F2d 92, 100 (5th Cir. 1979)(44 AFTR-2D 79-6095, 79-2 USTC [paragraph] 9709), "A criminal proceeding pursuant to Sec. 7206 'is an inappropriate vehicle for pioneering interpretations of tax. law.'" Although the scope of *Dahlstrom* was later narrowed by the Ninth Circuit in *Gerald L. Schulman*, 817 F2d 1355 (9th Cir. 1987)(59 AFTR2D 87-1158, 87-1 USTC [paragraph] 9334), the court reiterated that willfulness requires the intentional violation of a known legal duty. According to the *Schulman* court, the inquiry must be whether the law clearly prohibited the conduct alleged in the indictment.

(7) *George N. Foy*, 794 F Supp 835 (M.D. Tenn. 1992) (71 AFTR2d 93-735, 71A AFTR2d 93-4916,92-2 USTC [paragraph] 50,535).

(8) *Donald W. Warden*, 545 F2d 32 (7th Cir. 1976)(39 AFTR2d 77-439, 76-2 USTC [paragraph] 9790), citing *Delbert Null*, 415 F2d 1178, 1181 (4th Cir. 1969)(24 AFTR2d 69-5589, 69-2 USTC [paragraph] 9641).

(9) *Michael E. Gaudin*, 115 Sup. Ct. 2310 (1995). Although *Gaudin* is generally a pro-defendant case (see, e.g., *Harold H. Uchimura*, 107 F3d 1321 (9th Cir. 1997) (79 AFTR2d 97-1224, 97-2 USTC [paragraph] 50,245)), it could work against a defendant who might otherwise dispose of the case via a motion to dismiss. Such a motion would be granted by the court, based on the law, only if no material questions of fact were present. *Gaudin* would generally require the court to dismiss such a motion and put the material falsity issue to a jury.

(10) *Cecil J. Bishop*, 412 US 346 (1973)(32 AFTR2d 73-5018, 73-1 USTC [paragraph] 9459), rev'g and rem'g 455 F2d 612 (29 AFTR2d 72-622, 72-1 USTC [paragraph] 9252).

(11) See *Crooks*, note 2, at 1448, citing *Dahlstrom*, note 2, at 1427; *Berentje C.M. Pohlman*, 522 F2d 974, 976 (8th Cir. 1975)(36 AFTR2d 75-5642, 75-2 USTC [paragraph] 9677).

(12) *John L. Cheek*, 498 US 192 (1991)(67 AFTR2d 91-344, 91-1 USTC 150,012).



- (13) Murdock, 290 US 389,396 (1933)(13 AFTR 821, 3 USTC [paragraph] 1194).
- (14) Bishop, note 10, at 360; see also Peter Pomponio, 429 US 10 (1976)(38 AFTR2d 76-505, 76-2 USTC [paragraph] 9695).
- (15) James C. Buckner, 830 F2d 102 (7th Cir. 1987)(60 AFTR2d 87-5722, 87-2 USTC [paragraph] 9591).
- (16) As was more specifically noted in Foy, note 7, at 836, decided after Cheek, "the government must ... show that the defendant acted with the purpose and objective of violating the internal revenue laws of the United States."
- (17) Marc S. Kelley, 769 F2d 215 (4th Cir. 1985).
- (18) W. Garland Nealy, 729 F2d 961 (4th Cir. 1984) (53 AFTR2d 85-864, 84-1 USTC [paragraph] 9293).
- (19) James Daniel Orr, 864 F2d 1505 (10th Cir. 1989) (63 AFTR2d 89-518, 89-1 USTC [paragraph] 9220).
- (20) David M. Martin, 790 F2d 1215 (5th Cir. 1986)(58 AFTR2d 86-5186A, 86-2 USTC [paragraph] 9532).
- (21) Joseph J. Jerkins, 871 F2d 598 (6th Cir. 1989)(64 AFTR2d 89-5157, 89-2 USTC [paragraph] 9572).
- (22) John D. Clardy, 612 F2d 1139 (9th Cir. 1980)(45 AFTR2d 80-982, 80-2 USTC [paragraph] 9721).
- (23) Sec. 7701(a)(36) defines an income tax return preparer as any person who prepares for compensation, all or a substantial portion of a tax return or refund claim. Regs. Sec. 301.7701-15(a)(1), however, extends the definition to a person who furnishes the taxpayer with sufficient information and advice so that completion of the return is largely a mechanical matter. According to Regs. Sec. 301.7701-15(b)(2), a preparer has prepared a "substantial portion" of a return or refund claim if the schedule, entry or other portion of the return or refund claim involves gross income, deductions or credits of \$2,000 or more, or \$100,000 or more and 201% or more of the gross income (or, for an individual, adjusted gross income) shown on the return or refund claim.
- (24) AICPA Federal Taxation Executive Committee, Statements on Responsibilities in Tax Practice (1991 rev.).
- (25) See S. Rep. No. 97-494, 97th Cong., 2d Sess. 275 (1982); see also Stein, "Preparers Must Be Aware of Aiding and Abetting Penalty," 25 Taxation for Lawyers 298 (March/April 1997).
- (26) Sec. 6703(a) places the burden of proof on the government to demonstrate that the penalty is properly imposed.
- (27) Donnell R. Mattingly, 924 F2d 785 (8th Cir. 1991)(67 AFTR2d 91-494, 91-1 USTC

[paragraph] 50,068).

(28) Intertwined with the Cheek willfulness delineation, and the evidence of aiding or assisting noted by the Dahlstrom court at note 6, is the Fifth Amendment's due process requirement, which requires a showing of criminal liability only if the defendant had "fair notice" that the transaction was illegal. The Fourth Circuit in *James G. Mallas*, 762 F2d 361, 363 (4th Cir. 1985)(56 AFTR2d 85-5045,85-1 USTC 19408), recognized this constitutional principle in the context of criminal tax prosecutions: "Criminal prosecution for the violation of an unclear duty itself violates the clear constitutional duty of the government to warn citizens whether particular conduct is legal or illegal ... this same requirement arises from the rule of 26 U.S.C. 7206 that only a willful tax evasion is criminal."

#### EXECUTIVE SUMMARY

\* A Sec. 7206(2) offense contains three elements: (1) the act of aiding or assisting, (2) material falsity and (3) willfulness.

\* the courts have applied the willfulness element to require a finding beyond a reasonable doubt that the defendant acted with the specific intent to violate the tax laws.

\* A conviction under Sec. 7206(2) is punishable by a fine of not more than \$100,000 (\$500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

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