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CIVIL PENALTY FOR FRAUD UNDER THE 1954
INTERNAL REVENUE CODE

Papa v. Commissioner of Internal Revenue,
464 F.2d 150 (2d Cir. 1972)

In 1956 taxpayer paid a tax deficiency assessed against his 1954 income tax return. Subsequent investigations revealed similar discrepancies in other tax returns, whereupon the matter was referred to the Intelligence Division for possible fraud investigation. In 1963 the taxpayer was given statutory notice of a further deficiency for taxable year 1954, and it was concluded that both deficiencies were due to fraud.¹ Pursuant to section 6653(b) of the 1954 Internal Revenue Code, a penalty of fifty percent of the total underpayment was added to the tax. Taxpayer challenged that determination in Tax Court, alleging that a plain reading of the 1954 Code cannot support a penalty assessment on the initial deficiency which had been assessed and paid in 1956. The Tax Court agreed with the taxpayer.² On appeal, the Second Circuit Court of Appeals reversed. *Held*: amounts assessed against and paid by taxpayer subsequent to the filing of the taxpayer's original return but prior to the statutory notice of deficiency are included as part of the underpayment and are subject to a fifty percent penalty.³

Ad valorem civil penalties for fraud were originally enacted to deter the filing of fraudulent returns and to pay the high costs of fraud investigations.⁴ Under section 293(b) of the 1939 Code, a

1. In *Papa*, the court found that the entire underpayment was due to fraud. If only a fraction of the underpayment had been due to fraud, the penalty would have been the same because the penalty is computed on the entire underpayment, even though only a fraction of it was due to fraud. *Mensik v. Commissioner*, 328 F.2d 147 (7th Cir.), *cert. denied*, 379 U.S. 827 (1964); *P. Mazzoni*, 29 CCH Tax Ct. Mem. 104, 39 P-H Tax Ct. Mem. 122 (1970).

Collection of the deficiency assessed in 1963 would have been barred by the statute of limitations if fraud had not been proven for the year 1954. *Frank C. & Mary Papa*, 39 P-H Tax Ct. Mem. 469, 479-80 (1970).

2. *Frank C. & Mary Papa*, 39 P-H Tax Ct. Mem. 469 (1970).

3. *Papa v. Commissioner*, 464 F.2d 150 (2d Cir. 1972).

4. For sources stating the purpose for enacting fraud penalty statutes, see *Ise, The Relationship Between Civil and Criminal Tax Fraud and its Effect on the Taxpayer's Constitutional Rights*, 12 B.C. IND. & COM. L. REV. 1176 (1971); Note, *Collateral Estoppel in Tax Fraud Litigation: The Elimination of Joint and Several Lia-*

penalty of "50 percentum of the total amount of the deficiency" was imposed for fraud⁵ with "deficiency" being further defined in section 271(a) as the excess tax liability over the original tax return plus previous assessments.⁶

The 1954 Code, section 6653(b),⁷ changed the term "total amount of the deficiency" as used in 293(b) of the 1939 Code to "underpayment."⁸ In addition, section 6653(c)(1) explicitly omits

bility, 5 VALPARAISO U.L. REV. 636 (1972). Statutes imposing civil penalties for fraud in filing tax returns date back to 1864. For a discussion of the history of the fraud penalty, see *Commissioner v. Estate of Laymen*, 344 F.2d 763 (6th Cir. 1965).

The provision for civil fraud in filing income tax returns has not changed significantly since 1918. See the following sections for the fraud penalties in the income tax acts since 1918: INT. REV. CODE of 1954, § 6653(b); INT. REV. CODE of 1939, § 293(b); 1938, 1936, 1934, 1932, 1928 Acts, § 293(b); 1926, 1924 Acts, § 275(b); 1921, 1918 Acts, § 250(b).

5. INT. REV. CODE of 1939, § 293(b):

FRAUD:

(b) FRAUD—If any part of any deficiency is due to fraud with intent to evade tax, then 50 percentum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid

6. INT. REV. CODE of 1939, § 271:

DEFINITION OF DEFICIENCY:

(a) IN GENERAL—As used in this chapter in respect of a tax imposed by this chapter, "deficiency" means the amount by which the tax imposed by this chapter exceeds the excess of—

- (1) the sum of (A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—
- (2) the amount of rebate

7. INT. REV. CODE of 1954, § 6653(b):

FAILURE TO PAY TAX, FRAUD:

(b) FRAUD—If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a) [negligence]. In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

8. Underpayment as used in § 6653(b) is defined in INT. REV. CODE of 1954, § 6653(c):

FAILURE TO PAY TAX, DEFINITION OF UNDERPAYMENT:

(c) DEFINITION OF UNDERPAYMENT.—For purposes of this section, the term "underpayment" means—

- (1) INCOME, ESTATE, GIFT, and CHAPTER 42 TAXES—In the case of a tax to which section 6211 (relating to income, estate, gift, and chapter 42 taxes) is applicable, a deficiency as defined in that section (except that, for this purpose, the tax shown on a return referred to in section 621(a)(1)(A) shall be taken into account only if such return was filed on or before the last day prescribed for the filing

delinquent returns from consideration in assessing fraud penalties.⁹ Thus, the sections now provide that where an underpayment is due to fraud, fifty percent of this underpayment will be assessed as a fraud penalty. Underpayment is further defined as a deficiency under section 6211, that is, the excess tax liability over the amount shown on taxpayer's return plus previous assessments.

Though there are some differences between the 1939 and 1954 sections, the House and Senate Reports on the 1954 Code both indicated that no change was intended through the enactment of section 6211,¹⁰ and that section 6653(b) corresponded to fraud penalties in the then existing law.¹¹

of such return, determined with regard to any extension of time for such filing). . . .

Deficiency as used in § 6653(c) is defined in INT. REV. CODE of 1954, § 6211: DEFINITION OF A DEFICIENCY:

(a) IN GENERAL. For purposes of this title in the case of income, estate, gift, and excise taxes, imposed by subtitles A and B, and chapter 42, the term "deficiency" means the amount by which the tax imposed by subtitle A or B or chapter 42 exceeds the excess of—

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) the amount of rebates, as defined in subsection (b)(2), made.

9. INT. REV. CODE of 1954, § 6653(c)(1), quoted in note 8 *supra*. See Patten, *Handling Tax Fraud Cases*, 103 J. ACCOUNTANCY 58, 59 (1957). The author stated that the change in phraseology from "total deficiency" to "underpayment" was designed to close a possible loophole occurring when a taxpayer files only a delinquent return for the correct tax liability, hence resulting in a zero deficiency as defined in § 271 of the 1939 Code.

One other change in § 6653(b) of the 1954 Code included a provision dealing with fraud of the spouse in filing joint returns. See Note, *Collateral Estoppel in Tax Fraud Litigation*, 5 VALPARAISO U.L. REV. 636 (1972). Section 6653(d) was also a change from the 1939 Code and states that where a fraud penalty is assessed with respect to an underpayment of tax, the penalty for failure to file a return may not also be imposed. Under the 1939 Code the fraud penalty was assessed in addition to the penalty for failure to file a return resulting in aggregate penalties of as much as seventy-five percent. Jesse Ullman, 31 T.C. 690 (1958), *aff'd*, 295 F.2d 336 (5th Cir. 1961).

10. With regard to § 6211, the House Report states: "This section contains no material changes from existing law." H.R. REP. No. 1337, 83d Cong., 2d Sess. A 405 (1954).

With regard to § 6211, the Senate Report states: "This section, which is identical with that of the House bill, contains no material changes from existing law." S. REP. No. 1622, 83d Cong., 2d Sess. 573 (1954).

11. With regard to § 6653, the House Report states: "For all taxes for which returns are required, this section prescribes additions to the tax, corresponding to those

The Commissioner in *Papa* relied upon the precedent established under the 1939 Code, which held that the fraud penalty was assessed upon the difference between the tax liability and the amount shown on the original return.¹² In the leading case of *Maitland A. Wilson*,¹³ the taxpayer contended that the fraud penalty could not be assessed on the amounts assessed and paid after filing the original return but prior to the assertion of a fraud penalty. The court rejected the taxpayer's argument and held that the phrase "total amount of the deficiency" defined in section 293(b) of the 1939 Code meant "the total understatement in tax liability on the return, whether later determined in one or several deficiencies."¹⁴ Similarly, in *Romm v. Commissioner*¹⁵ the court held that the "total deficiency" included a voluntary payment of taxes made after the tax investigation had commenced, but before the notice was sent.¹⁶

Contrary to the legislative history and consensus among commentators,¹⁷ the taxpayer in *Papa* contended that the changes in

of existing law relating to the income tax, for underpayments of tax resulting from negligence (5 percent of the underpayment) or fraud (50 percent of the underpayment)." H.R. REP. No. 1337, 83d Cong., 2d Sess. A 419 (1954).

With regard to § 6653, the Senate Report states: "For all taxes for which returns are required, this section prescribes additions to the tax, corresponding to those of existing law relating to the income tax, for underpayments of tax resulting from fraud (50 percent of the underpayment)." S. REP. No. 1622, 83d Cong., 2d Sess. 591 (1954).

12. There are four typical situations that occur whereupon a fraud penalty may be imposed. 1) Taxpayer files return, then voluntarily files an amended return, fraud notice sent: e.g., *Romm v. Commissioner*, 245 F.2d 730 (4th Cir. 1957); *Middleton v. Commissioner*, 200 F.2d 94 (4th Cir. 1952); *George M. Still*, 19 T.C. 1072 (1953); *Herbert Eck*, 16 T.C. 511 (1951), *aff'd per curiam*, 202 F.2d 750 (2d Cir. 1953) (on authority of *Middleton*), *cert. denied*, 346 U.S. 822 (1953); *Aaron Hirschman*, 12 T.C. 1223 (1949). 2) Taxpayer files return, IRS assesses a deficiency, fraud notice sent: e.g., *Maitland A. Wilson*, 7 T.C. 395 (1946). 3) Taxpayer files return, fraud notice sent: e.g., *Joseph A. Cirillo*, 20 CCH Tax Ct. Mem. 956, 30 P-H Tax Ct. Mem. 1044 (1961), *aff'd in part and rev'd in part*, 314 F.2d 478 (3d Cir. 1963). 4) Taxpayer files late or no return, fraud notice sent: e.g., *Herbert C. Broyhill*, 27 CCH Tax Ct. Mem. 117, 37 P-H Tax Ct. Mem. 139 (1968), *Estate of Sam Maceo*, 23 CCH Tax Ct. Mem. 258, 33 P-H Tax Ct. Mem. 284 (1964). In the above situations, a court of appeals has ruled under the 1939 Code that the fifty percent penalty is assessed against the difference between the tax liability and the amount shown on the original return, regardless of the fact that amended returns are filed or assessments paid.

13. 7 T.C. 395 (1946).

14. *Id.* at 399.

15. 245 F.2d 730 (4th Cir. 1957).

16. *Id.* at 736.

17. See 10 A. MERTENS, LAW OF FEDERAL INCOME TAXATION 55.09 n.85.2 (J. Malone ed. 1972); Beck, *When Avoidance: When Evasion*, N.Y.U. 18TH INST. ON FED. TAX, 1093 (1960): "Section 6653(b) provides that if any part of any underpay-

phraseology in the 1954 Code, primarily the change from "total deficiency" to "underpayment," were of such significance that the precedent value of cases decided under the 1939 Code was negated,¹⁸ thereby requiring that the court interpret the statute in the 1954 Code solely according to the language of the Code.¹⁹ While a plain reading of the statutes could support the taxpayer's contention that the amount initially assessed prior to the fraud notice is not an underpayment as defined in the Code, the Supreme Court has held that language in a tax statute, especially in provisions of a penal nature, should be interpreted in accordance with legislative intent although such interpretation "is not in exact and literal obedience to the wording of the law."²⁰

In further support of the Commissioner's contention that there are no significant differences between the fraud sections of the 1939 and 1954 Codes, two recent decisions dealing with delinquent returns rather than assessments have held that the only difference between the Codes was that the 1954 Code is more explicit in providing that only a timely return is to be considered.²¹

ment of tax is due to fraud, there shall be added to the tax an amount equal to 50% of the underpayment. This section stems from section 293(b) of the 1939 Code, and, except for minor changes in phraseology, is substantially the same as that section." Butler, *Income Tax Fraud—Basic Principles for the General Practitioner*, 37 ORE. L. REV. 199, 206 (1958): "In reading civil-fraud cases, there will be some confusion since most fraud cases to date have been tried under IRC of 1939. Section 293(b) of that act (the counterpart of the present section 6653(b)) imposed the fraud penalty on the 'deficiency'. For most purposes the term 'deficiency' and 'underpayment' are synonymous."

18. Prior to the decision in the principal case, no court of appeals had specifically determined whether Congress intended to disturb the existing law regarding fraud penalties for income tax when it enacted the 1954 Code. See *Commissioner v. Estate of Layman*, 344 F.2d 763 (6th Cir. 1965), for treatment of the fraud penalty for estate tax purposes under the 1954 Code.

19. The same type of argument, requesting the court to apply a literal interpretation of the statute, was employed by taxpayers under the 1939 Code. See cases cited note 12 *supra*.

20. *United States v. A. Graf Distilling Co.*, 208 U.S. 198, 205 (1908), citing with approval *Wisniewski v. United States*, 247 F.2d 292, 296 (8th Cir. 1957); *United States v. Goldberg*, 225 F.2d 180, 185 (8th Cir. 1955) (Commissioner's non-literal interpretation of a penal section of a tax statute upheld).

21. In *Herbert C. Broyhill*, 27 CCH Tax Ct. Mem. 117, 37 P-H Tax Ct. Mem. 139 (1968), where the taxpayer filed only delinquent returns for the years in question, the Tax Court declared that, "It is well established that where no returns, except delinquent returns, are filed the deficiency or underpayment for purposes of section 293(b) of the 1939 Code and section 6653(b) of the 1954 Code is the correct tax due rather than the excess of the correct tax over the tax shown on the delinquent returns."

Beyond legislative history and stare decisis, the court in *Papa* felt that "the Tax Court's interpretation of the interplay of section 6211 (a)(2)(B) with section 6653(b) would 'nullify the fraud penalty.'"²² Under the Tax Court's interpretation in *Papa*, if a taxpayer learned that an investigation had begun, and then filed an amended return, there would be no deficiency or underpayment upon which to base the fraud penalty. Since the IRS must first investigate tax returns before they become aware of any fraud, a taxpayer is always given notice prior to a fraud assessment.²³ While the Tax Court's interpretation would result in the collection of income tax fraudulently withheld, it would not assess a monetary penalty that would deter future filing of fraudulent returns nor would it repay some of the high costs of the IRS tax investigations.

27 CCH Tax Ct. Mem. at 122, 37 P-H Tax Ct. Mem. at 144. In *Cirillo v. Commissioner*, 314 F.2d 478 (3d Cir. 1963), *affg in part and rev'g in part* 20 CCH Tax Ct. Mem. 956, 30 P-H Tax Ct. Mem. 1044 (1961), the Third Circuit declared that the only difference between the two Codes was that section 6653(c)(1) of the 1954 Code explicitly provides that only a timely return is to be considered. 314 F.2d at 484. See also *Stoltzfus v. United States*, 398 F.2d 1002 (3d Cir. 1968); *George Arconti*, 39 P-H Tax Ct. Mem. 1033 (1970); *Willie B. Robinson*, 27 CCH Tax Ct. Mem. 437, 37 P-H Tax Ct. Mem. 487 (1968).

22. 464 F.2d 150 (2d Cir. 1972).

23. See *George M. Still*, 19 T.C. 1072, 1077 (1953); 10 A. MERTENS, LAW OF FEDERAL INCOME TAXATION 55.09 n.85.4 (J. Malone ed. 1972).