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I. Distinguishing Between Tax Avoidance and Tax Evasion

The distinction between tax avoidance and tax evasion can often be murky. The classic distinction between the two is from Oliver Wendell Holmes, who wrote, “When the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as evasion, what is meant is that it is on the wrong side of the line...”¹ Thus, the distinguishing characteristic of evasion is illegality.

A. Tax Avoidance

Tax avoidance is within the legal framework of the tax law, provided that the means used to avoid taxes are real and legally effective to accomplish the desired result. “Over and over again courts have said there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right for nobody owes any public duty to pay more than the law demands; taxes are enforced exactions not voluntary contributions. To demand more in the name of morals is mere cant.”² Tax avoidance may consist of using loopholes in the tax law to reduce tax liability, and “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * But the question for determination is whether what was done,

¹*Bullen v. Wisconsin*, 240 U.S. 625, 630 (1916).

²*Commissioner v. Newman*, 159 F.2d 848, 850-851 (2d Cir. 1947) (L. Hand, J., dissenting), cert. denied, 331 U.S. 859 (1947).

apart from the tax motive, was the thing which the statute intended.”³

Where transactions lack a business purpose and are undertaken solely for tax avoidance purposes, their tax consequences will be determined based on substance and not form.⁴ The inquiry into whether a transaction has economic substance focuses on (1) whether the transaction at issue had any practical economic consequences other than the creation of tax benefits and (2) whether the taxpayer had a valid business purpose or profit motive.⁵ In the Tax Court, the taxpayer bears the burden of proving that the challenged transaction was not a sham transaction lacking economic substance.⁶

The economic substance doctrine⁷ has been used by courts to prevent taxpayers from undermining the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.⁸ To treat a transaction as a sham, the court must find the taxpayer was not motivated by any business purpose other than obtaining tax benefits by entering the transaction, and that the transaction has no economic substance because

³*Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

⁴*Id.*

⁵*ACM Pship. v. Commissioner*, 157 F.3d 231, 247-248 (3d Cir. 1998), *affg. on this issue* T.C. Memo. 1997-115.

⁶Rule 142(a), Tax Court Rules of Practice and Procedure; *Sheldon v. Commissioner*, 94 T.C. 738, 753 (1990).

⁷See ROBERT S. FINK, *TAX CONTROVERSIES: AUDITS, INVESTIGATIONS, TRIALS*, ch. 16.07 (Matthew Bender & Co., Inc. 2013) for discussion of economic substance doctrine in criminal tax cases.

⁸Judge James S. Halpern, *Putting the Cart Before the Horse: Determining Economic Substance Independent of the Language of the Code*, 30 Va. Tax. Rev. 327, 329 (2010).

no reasonable possibility of a profit exists.⁹

B. Tax Evasion

Tax evasion, or attempted evasion, is an attempt to evade or defeat tax (or the payment of tax) in any manner, the existence of a tax deficiency (or tax due and owing in an evasion of payment case), an affirmative act of fraud, and willfulness. The difference between willful failure to pay a tax when due and willful attempt to defeat and evade one, is not necessarily easy to detect or define.¹⁰ The word “willfully” connotes a voluntary, intentional violation of a known legal duty.¹¹

II. Tax Evasion Penalties

A. Penalties in the Internal Revenue Code (Title 26)

There are both civil and criminal penalties, potential fines and prison time for tax evasion.¹² Civil penalties include the section 6702 penalty for filing a frivolous return, the various accuracy-related penalties in section 6662, and the section 6663 civil penalty for fraud. Section 6702 imposes a \$5,000 penalty against a taxpayer where the taxpayer files a purported income tax return, the purported return lacks the information needed for the Commissioner to judge the substantial correctness of the taxpayer’s self-assessment, and the taxpayer’s position is frivolous or demonstrates a desire to delay or impede the administration of Federal income tax

⁹*Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

¹⁰*Spies v. United States*, 317 U.S. 492 (1943).

¹¹*United States v. Bishop*, 412 U.S. 346 (1973) (citing *United States v. Murdock*, 290 U.S. 389 (1933) and *Spies v. United States*, 317 U.S. 492 (1943), respectively, and noting that [the Court] has formulated the requirement of willfulness as “bad faith or evil intent,” or “evil motive and want of justification in view of all the financial circumstances of the taxpayer.”

¹²Michael Hatfield, *Tax Lawyers, Tax Defiance, and the Ethics of Casual Conversation*, 10 Fla. Tax Rev. 841, 860 (2011).

laws. Section 6663 imposes a penalty of 75 percent of the portion of an underpayment of tax attributable to fraud. This penalty is coordinated with the accuracy-related penalty in section 6662 so that the accuracy-related penalty is not applicable to the portion of the underpayment that is subject to the fraud penalty. A tax return must have actually been filed for the section 6663 fraud penalty to apply.¹³

Criminal penalties include those in section 7201, which imposes up to a \$100,000 fine and five years imprisonment for willfully attempting to evade or defeat taxation, and in section 7203, which imposes up to a \$25,000 fine and one year jail term for willfully failing to file a return, supply information, or pay tax. Section 7206(1) imposes up to a \$100,000 fine (\$500,000 for a corporation) and/or up to three years in prison for filing a false return.¹⁴ Section 7206(2) imposes up to a \$100,000 fine (\$500,000 for corporations) and/or up to three years in prison for aiding or assisting in the preparation of a false return. Furthermore, courts have authority under section 6673 to sanction frivolous, anti-tax arguments.¹⁵

The conduct of tax evasion may violate or implicate non-tax federal crimes, and the relationship between tax crimes and non-tax crimes is discussed in several articles.¹⁶ For example, a criminal tax case may be cast as a conspiracy prosecution under 18 U.S.C. section

¹³See ROBERT S. FINK, *TAX CONTROVERSIES: AUDITS, INVESTIGATIONS, TRIALS*, ch. 15.04 (Matthew Bender & Co., Inc. 2013) for additional discussion of the fraud penalty.

¹⁴The elements of the offense are the making and subscribing of a return, statement or other document which states that it is signed under penalty of perjury, knowledge that the document is not true as to any material matter, and willfulness.

¹⁵Hatfield, *supra* note 10.

¹⁶For discussions of the convergence and contrast of the Codes, see Geraldine Szott Moohr, *Introduction: Tax Evasion as White Collar Fraud*, 9 Hous. Bus. & Tax. L.J. 207 (2009); ROBERT S. FINK, *TAX CONTROVERSIES: AUDITS, INVESTIGATIONS, TRIALS*, ch. 16.08 (Matthew Bender & Co., Inc. 2013).

¹⁷MARVIN J. GARBIS ET AL., TAX PROCEDURE AND TAX FRAUD, CASES AND MATERIALS 538 (West Group, 3d ed. 1992).