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TAX LITIGATION ISSUES

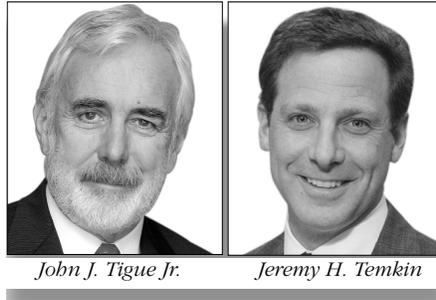
BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

Revenge of the Tax Protesters

Tax protesters, or individuals who claim that they are not legally required to pay taxes, have been around for a long time. In recent years, however, the number of tax protesters appears to have increased as numerous individuals and groups actively market and sell a variety of materials supporting the claim that American citizens are not obligated to pay income taxes.

Among the arguments raised by tax protesters are: (1) that the 16th Amendment to the Constitution, which authorizes income taxes, was never ratified; (2) that the Internal Revenue Service (IRS) was never properly established by Congress and is an illegal entity; (3) that the Internal Revenue Code (IRC) was not properly enacted; (4) that “income” is not defined or does not include wages, tips or other compensation; and (5) that only foreigners and citizens of U.S. territories (such as Puerto Rico and Guam) and Washington, D.C., are obliged to pay taxes. Despite the fact that a majority of the population may classify these arguments and their proponents as outlandish and incredible, many people are citing these assorted theories as reasons not to pay taxes.

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As a result, the IRS has increased its focus on prosecuting individuals who make such arguments, which it views as willful tax evasion. In March of this year, IRS Commissioner Mark W. Everson warned taxpayers of the dangers of succumbing to tax protesters. He stated, “Every filing season, thousands of taxpayers hear groundless theories suggesting that they don’t have to pay taxes or file returns. We want people to know the truth about these frivolous arguments: they don’t work.”¹ Available on the IRS’s Web site are documents detailing the agency’s position, including IRS Notice 2005-30, which describes 23 arguments made by tax protesters and five revenue rulings issued in conjunction with the notice that deal with specific protester claims frequently made to the IRS. Finally, the IRS has created and maintains a 56-page document entitled “The Truth About Frivolous Tax Arguments,” addressing the arguments promoted by tax protesters and their organizations. This document, also available on the service’s Web site, cites recent cases decided by the courts against tax protesters.

IRS Chief Counsel Donald L. Korb

noted that courts “have consistently rejected ...arguments [raised by tax protesters] and imposed substantial penalties on those taking these unsupportable positions. Those potentially tempted by these schemes need to realize that they carry a heavy price for both the taxpayers and the promoters.”² As set forth in IRS Notice 2005-30, civil and criminal penalties apply to taxpayers who make frivolous arguments. Civil penalties include a \$500 penalty for filing a frivolous income tax return and a penalty of up to \$25,000 if a taxpayer pursues frivolous arguments in court.³ Moreover, appellate courts not only have affirmed the Tax Court’s imposition of penalties on tax protesters, but also have imposed additional penalties in some circumstances.⁴ Tax protesters and promoters of tax protest arguments also may face criminal prosecution for attempting to evade or defeat taxes, willful failure to file a return or making false statements on a return, statement or other document.⁵

Indeed, the IRS’s successful pursuit and punishment of tax protesters is evidenced by the agency’s statistics with respect to one type of protester referred to as a “nonfiler.” The IRS describes nonfilers as those who rely on the “zero tax theory” to argue they are not subject to tax on their wages and other income earned or derived within the United States. For the fiscal year 2004, the IRS initiated 417 investigations into those tax protesters who did not file returns or filed returns with zero tax. Of those investigated, 317 were referred for prosecution and 277 indictments or

informations were brought as a result. Moreover, during fiscal 2002, 194 individuals identified by the IRS as nonfiling tax protesters were sentenced, with an incarceration rate of 92.3 percent, up more than 10 percent from the prior year, and with an average prison term of 36 months.⁶

Despite advances by the IRS in its pursuit of tax protesters, the tax protest movement is not fading into the sunset. Rather, it continues unabated, strengthened by occasional successes in the courtroom. These courtroom victories are lauded on the tax protesters' Web sites, while losses are diminished or ignored. Furthermore, as noted by Commissioner Everson, a 2003 study shows that 17 percent of Americans believe that it is OK to cheat on taxes, up from 11 percent in 1999.⁷

The Criminal Case of Joseph Banister

The most recent victory by the tax protest movement occurred in a federal courtroom in California. In November 2004, Joseph Banister, a former IRS investigator and practicing certified public accountant involved in the tax protest movement, was indicted on charges that he helped prepare false tax returns. Specifically, Mr. Banister was charged with three counts of assisting in the preparation of false tax returns and one count of conspiracy to defraud the U.S. government. These charges stemmed from Mr. Banister's preparation of tax returns for a small California company run by another well-known tax protester, Walter Thompson. Upon his indictment, Commissioner Everson commented that "Joe Banister, a former IRS agent, knew exactly what he was doing. Tax professionals and employers who break the law will be held accountable."⁸

However, on June 23, 2005, a jury acquitted Mr. Banister of all charges. According to press reports, the jury apparently rejected the government's argument that Mr. Banister's oral and

written publication of materials protesting the payment of taxes to the federal government was evidence of his wrongful intent in preparing the company's tax returns. In rebuttal, Mr. Banister had introduced an April 2001 e-mail between a Department of Justice lawyer, who previously had worked with Mr. Banister when he was at the IRS, and the chief of the Western Division of the Department of Justice's Tax Division, which apparently showed that the government viewed Mr. Banister to be a visible player in the tax protest movement. Using this evidence, Mr. Banister argued that the government's prosecution was personal rather than based on evidence of any wrongdoing. He argued that in preparing the protest returns, he was merely trying to obtain answers to questions posed by his client regarding the legality of federal income taxes.⁹

Immediately after the trial, two jurors related their view that although the IRS may have disagreed with the position taken by Mr. Banister in preparing the tax returns, the government had failed to prove that the returns contained any false information. Further, they said that Mr. Banister was honestly trying to get answers to his questions, which the government consistently refused to provide. Upon leaving the courtroom, Mr. Banister reportedly was met with cheers from a crowd of supporters including approximately 50 fellow tax protesters. His attorney claimed that the verdict meant that "American citizens have the right to ask the government questions and the government has a duty to answer in good faith."¹⁰

In an interesting twist to the case, Mr. Banister's client, Mr. Thompson, had been convicted in a separate trial of failure to withhold and pay taxes from the paychecks of his employees, and was sentenced to six years in prison. Although Mr. Thompson also was acquitted of the conspiracy charges against him, his conviction as compared with Mr. Banister's acquittal may mark a difference in the way juries apply criminal tax laws in

cases involving taxpayers as opposed to their professional advisors or accountants.

The IRS declined to comment on the verdict in favor of Mr. Banister, but the decision has received much attention within the tax protest movement. Details of the case are thoroughly documented on Web sites maintained by Mr. Banister and the organizations in which he is involved, and the verdict is heralded as a landmark in the movement's fight against taxes. However, it remains to be seen whether the verdict portends larger problems for the IRS in its pursuit of tax protesters.

'Schulz v. IRS'

Unlike its loss in the *Banister* trial, the IRS won its case against Robert Schulz, the chairman of a tax protester organization called We the People Foundation for Constitutional Education Inc. However, as detailed in our March 2005 article in this journal, the IRS's victory was far from unambiguous. In *Schulz v. Internal Revenue Service (Schulz I)*,¹¹ Mr. Schulz, acting pro se, sought to quash an administrative summons he had received from the IRS. A magistrate judge found that the district court lacked jurisdiction to hear Mr. Schulz's motion because the IRS had neither attempted to enforce the summons in court nor sought any other remedy or sanction. Mr. Schulz appealed this decision, which was affirmed by the district court and, ultimately, the U.S. Court of Appeals for the Second Circuit.

The Second Circuit's per curiam opinion went beyond the jurisdictional issue, however, and found that "absent an effort to seek enforcement through a federal court, IRS summonses apply no force to taxpayers, and no consequence whatever can befall a taxpayer who refuses, ignores, or otherwise does not comply with an IRS summons until that summons is backed by a federal court order." Furthermore, the court found that where a court grants an IRS request for enforcement, the taxpayer must be given a reasonable opportunity to comply and "cannot be held in contempt, arrested,

detained, or otherwise punished for refusing to comply with the original IRS summons, no matter the taxpayer's reasons or lack of reasons for so refusing." Rather, only an individual's refusal to comply with an order of the district court would subject him to sanctions.

The IRC contains two relevant provisions that pertain to the enforcement of administrative summons. Section 7604(b) provides that the IRS may apply to the court for an "attachment" against the taxpayer for contempt "to enforce obedience to the requirements of the summons and to punish [the taxpayer] for his default or disobedience." And §7210 provides that individuals who "neglect to appear or to produce" summoned documents may be charged with a misdemeanor.

In *Schulz I*, the IRS argued that some or all of these sanctions may be imposed by the court as a result of a taxpayer's failure to comply with the original summons, rather than a failure to obey a subsequent court order enforcing that summons. As noted above, the Second Circuit rejected this position, relying on the Supreme Court's opinion in *Reisman v. Caplin*.¹² Shortly after the Second Circuit released its opinion in *Schulz I*, the We the People Foundation proclaimed the opinion a victory for taxpayers, posting the headline "Tax Payers Free to Ignore IRS Summons" on its Web site.¹³ The article went on to say that the decision had "nullified key enforcement provisions of the [code], stripping the IRS of much of its power to compel compliance with its administrative demands for personal and private property."

Apparently troubled by the decision and its fallout, the IRS moved to amend the opinion or, in the alternative, extend the time for filing a petition for rehearing en banc. In its motion, the IRS distinguished between a taxpayer who in good faith refused to comply with an administrative summons from those whose refusal was willful or in bad faith. In the case of the latter, the IRS argued that such individuals were subject to prosecution for their initial noncompli-

ance, not just for their failure to comply with a subsequent court order. Furthermore, the IRS argued that the attachment remedy set forth in §7604(b) of the code applied to a taxpayer's initial failure to comply with the administrative summons as well.

The Second Circuit granted the IRS's motion for rehearing, but only for the limited purpose of clarifying its prior opinion. In *Schulz v. IRS (Schulz II)*, the court modified its prior opinion only to recognize that §7604(b) of the code allowed courts to issue attachments or arrests, even without a prior court order enforcing the administrative summons, "to ensure attendance at an enforcement hearing '[i]f the taxpayer has contumaciously refused to comply with the administrative summons and the Service fears he may flee the jurisdiction.'"¹⁴

Otherwise, the court's holding as set forth in *Schulz I* remained intact. Thus, a party who refuses, ignores, or otherwise does not comply with an IRS summons cannot be punished until that summons is backed by a federal court order. Moreover, once enforcement of the order is sought, the taxpayer must be given a reasonable opportunity to respond and, if the government's request is granted, the taxpayer must be given a reasonable time to comply. The Second Circuit reasoned that failure to provide such an opportunity for full "judicial review before any coercive sanctions may be imposed" would result in a violation of the taxpayer's constitutional due process.¹⁵ While the IRS still may seek review of *Schulz II* by filing a petition for rehearing en banc (as authorized by the Second Circuit's opinion) or a petition for a writ of certiorari, the impact of this case is significant in that it diminishes the IRS's power to enforce its subpoenas against taxpayers.

Conclusion

In all likelihood, the results of the *Banister* and *Schulz* cases, coupled with the continued strength of the tax protest movement, has given the IRS pause. With

many successes under its belt, however, it is unlikely that the IRS will be discouraged in its pursuit of tax protesters or the deconstruction of the often "frivolous" arguments they make.



1. Press Release, Internal Revenue Service, "IRS Rebuts Those Making Frivolous Arguments on Paying Taxes" (March 14, 2005) (available at <http://www.irs.gov/irs/article/0,,id=136751,00.html>).

2. *Id.*

3. 26 U.S.C. §§6702 and 6673.

4. Recently, the Fifth Circuit added \$4,000 to the Tax Court's initial sanction, *Raynor v. Comm'r*, 2003 U.S. App. Lexis 14173 (5th Cir. 2003), and the First Circuit imposed a \$2,000 sanction against a taxpayer who intentionally challenged a collection action in District Court rather than Tax Court, *Marino v. Brown*, 357 F.3d 143 (1st Cir. 2004).

5. 26 U.S.C. §§ 7201, 7203 and 7206. See also *Hillen v. Comm'r*, Docket No. 1441-03L (2004) (imposing penalty of more than \$14,000 against attorney who made frivolous arguments on behalf of his client); <http://www.irs.gov/compliance/enforcement/article/0,,id=133814,00.html> (listing more than 50 civil and criminal injunctions brought against promoters of tax protest arguments in 2005).

6. Internal Revenue Service, Statistical Data—Nonfiler Enforcement (available at <http://www.irs.gov/compliance/enforcement/article/0,,id=106380,00.html>).

7. See Hank Ezell, "Much to IRS's Chagrin, Tax Protesters Won't Go Away," Cox News Service, July 18, 2005 (available at <http://www.bradenton.com/mld/bradenton/business/12159344.htm?template=contentModules/printstory.jsp>).

8. Peymon Mottahedeh, "Famed IRS Whistleblower Gets Tax Fraud Acquittal," American Free Press, Issue # 28, July 14, 2005 (available at www.americanfreepress.net/html/famed_irs_whistleblower.html).

9. *Id.*

10. David Cay Johnston and Carolyn Marshall, "Protesters Win a Case Over I.R.S.; U.S. Jury Acquits Preparer of Returns," The New York Times, June 24, 2005.

11. 395 F.3d 463, 465 (2nd Cir. 2005); see John J. Tigue and Jeremy H. Temkin, Tax Litigation Issues: "Recent Second Circuit Cases", New York Law Journal, March 17, 2005.

12. 375 U.S. 440 (1964).

13. See <http://www.givemeliberty.org>.

14. 413 F.3d 297, 299 n.1 (2nd Cir. 2005).

15. *Id.* at 298-299, 303.

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