THOMAS K. & KATHY FRYE 218 SHERATON DRIVE ANDALUSIA, AL 36420,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 09-588
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Thomas K. and Kathy Frye (together "Taxpayers") for 2001 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on January 12, 2010. The Taxpayers and their representatives, Bill Rose and Brad Anderson, attended the hearing. Assistant Counsel Lionel Williams represented the Department.

This is a penalty waiver case. The Taxpayers filed their 2001 Alabama income tax return in early 2008. The return reported zero income. The Department received IRS information showing that the Taxpayers had received substantial income in 2001. It consequently assessed the Taxpayers for the tax due, plus penalties and interest.

The Taxpayers concede that they owe the tax and interest due as assessed by the Department. They argue, however, that the late filing, late payment, and frivolous appeal penalties assessed by the Department should be waived for reasonable cause.

The facts are undisputed.

Thomas Frye (individually "Taxpayer") has worked as a pharmacist in Andalusia, Alabama since before 2000. The Taxpayers routinely filed Alabama income tax returns and paid the tax due on the Taxpayer's wages until 2000. In 2000, the Taxpayers received a random e-mail questioning the legality of the federal income tax, and stating that wages

may not be subject to the tax. They subsequently participated in a conference call concerning the legality/applicability of the income tax. They followed up on the issue by paying $5,000 to have Mrs. Frye attend a seminar in Cancun, Mexico in May 2000. A former IRS agent and others espoused at the seminar that wage earners were not liable for federal income tax, and by extension also State income tax.

The Taxpayers eventually became convinced that they were not liable for federal or Alabama income tax on the Taxpayer's wages. They pursued the matter further by contacting American Tax Consultants, a business that had participated in the Cancun seminar. They paid that company $3,000, and the company thereafter prepared and filed "tax statements" with the IRS on behalf of the Taxpayers. Although not clear from the record, the statements presumably declared that the Taxpayers were not liable for federal income tax.

The Taxpayer directed his employer to stop withholding federal and State income tax from his wages in 2000. The Taxpayers thereafter intentionally refused to file federal and State income tax returns for 2000 and subsequent years.

The IRS contacted the Taxpayers in 2003 concerning their delinquent federal returns. The Taxpayers subsequently hired IMF Decoders, another company in the tax "consulting" business. That company charged the Taxpayers $2,000 to represent them.

IMF Decoders helped the Taxpayers obtain their federal tax information from the IRS through the Freedom of Information Act. The Taxpayers forwarded the IRS information to IMF Decoders, which notified the Taxpayers that the IRS information showed that they lived in Guam (or the Virgin Islands), and that their occupation was "manufacturers other – auto

chassis." The Taxpayers thus became convinced that the IRS had posted fraudulent information in their file in an illegal attempt to subject them to federal tax. The Taxpayer testified as follows:

> The Internal Revenue Service had put fraudulent information in our records, with a belief that they probably do this to everybody; and unless that information is rebutted, which we did, then that becomes the prima facie evidence that is used to win a victory in court if it ever comes to court.
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> So at that point, we were convinced, you know, that the records contained fraudulent information and that this was being used against us as the evidence that we must pay taxes. So we said, hey, that's not right; that's not right and we don't believe we have to pay the tax.

T. at 12 – 13.

The IRS instigated a criminal tax evasion investigation of the Taxpayers in 2006. The IRS investigation motivated the Taxpayers to contact their current representatives for legal advice in 2007. They still believed after meeting with the representatives that they were not required to file returns and pay income tax. They nonetheless decided in late 2007 to hire a tax preparer recommended by IMF Decoders to prepare and file their 2000 through 2006 State and federal returns. The Department received the Taxpayers' 2000 through 2006 Alabama returns in early 2008. The returns reported zero income. As indicated, the Department subsequently assessed the Taxpayers for the 2001 tax due, plus penalties and interest, based on IRS information. [1]

The Taxpayers argue that the penalties in issue should be waived for reasonable cause based on their good faith misunderstanding of the law. They cite Code of Ala. 1975,

[1] The Department is currently in the process of assessing the Taxpayers for 2000 and 2002 through 2006 based on IRS information. Those assessments are presumably being held in abeyance pending this appeal.

§40-2A-11(h), which specifies that reasonable cause to waive a penalty "shall include, but not be limited to, those instances in which the taxpayer has acted in good faith."

The Taxpayers cite the Administrative Law Division's holding in *Dubose Construction v. State of Alabama*, S. 05-917 (Admin. Law Div. 3/2/2006), in support of their position. In *Dubose*, the individual owner of several corporate entities hired a trusted CPA to pay the corporations' bills, maintain the corporations' books and records, and prepare some of the corporations' tax returns. The owner eventually discovered that various tax liens had been filed against his corporations, and that there were discrepancies in the corporations' books and records. An outside CPA firm audited the corporations' records and discovered that the CPA had embezzled hundreds of thousands of dollars from the corporations.

The Department subsequently assessed the corporations for the unpaid tax due, plus penalties and interest. The corporations paid the tax, penalties, and interest, and then petitioned for a refund of the penalties. The Department denied the refund, and the corporations appealed to the Administrative Law Division.

The Administrative Law Division first noted that "reasonable cause" to waive a federal penalty pursuant to 26 U.S.C. §6651(a)(1) requires that a taxpayer must have exercised "ordinary business care and prudence", citing *United States v. Boyle*, 105 S.Ct. 687, 689 (1985). The Division held that the "good faith" standard specified in §40-2A-11(h) was broader than the federal standard in §6651(a)(1). It then found that while the wrongdoing CPA had not acted in good faith, the owner had because "(The owner) trusted (the CPA) and reasonably believed in good faith that (the CPA) was timely filing and paying the corporations' taxes." *Dubose* at 5. The Division thus concluded that the penalties

should be waived for cause.

> The U.S. Supreme Court stated in *Boyle* that given the large number of taxpayers that file returns, "our system of self-assessment . . . simply cannot work on any basis other than one of strict filing standards." *Boyle*, 105 S.Ct. at 691. But also essential to the system is that it be perceived as fair. Penalizing Dubose's closely held corporations would in effect be penalizing Dubose. Dubose lost hundreds of thousands of dollars because a trusted employee embezzled from his companies. Dubose could not have reasonably expected or foreseen Mills' illegal acts, and further penalizing him would be considered unfair by the vast majority of Alabamians. Under the extraordinary circumstances in this case, and the broad definition of reasonable cause in Reg. 810-14-1-.33.01 and Rev. Proc. 97-003, the penalties in issue are waived for reasonable cause.

Dubose at 8.

As indicated, the penalties were waived in *Dubose* because the individual that owned the corporations, who was in substance the one being penalized, reasonably believed in good faith that his in-house CPA was timely filing all returns and paying the tax due. In this case, however, the Taxpayers may have been convinced (or convinced themselves) that they were not liable for federal and State income tax on the Taxpayer's wages, but that belief was not reasonable.

It is generally understood that individuals are liable for State and federal income tax on wages. The Taxpayers understood that fact, and correctly reported and paid Alabama and federal income tax on the Taxpayer's wages in the years before 2000. The Taxpayers were sold a bill of goods by various tax "consultants" in 2000 that apparently convinced them that they were somehow different from other wage earners, and thus not liable for tax on the Taxpayer's wages. They accepted the tax consultant's bogus "tax protestor" arguments without consulting with a reputable CPA or tax attorney. The Taxpayers' actions in doing so were not reasonable.

In *Dubose*, the Administrative Law Division held that penalizing the innocent owner for the misdeeds of his in-house CPA's illegal acts "would be considered unfair by the vast majority of Alabamians." *Dubose* at 8. I do not believe, however, that the average Alabama wage earner who duly pays income tax on those wages would think it unfair to penalize the Taxpayers for their willful and intentional failure to file Alabama returns and pay the tax due.

The Taxpayers' position in substance is that there is reasonable cause to waive the penalties because they subjectively believed in good faith that they were not legally required to pay income tax on the Taxpayer's wages. I disagree.

In the context of a federal criminal prosecution for willfully evading income tax, the U.S. Supreme Court has held that if the taxpayer truly believed in good faith that he owed no taxes, he could not be found guilty. See, *Cheek v. United States*, 111 S. Ct. 604 (1991). That is, a taxpayer cannot be found guilty of willful criminal tax evasion if the taxpayer had a subjective belief that he was not liable for the tax. The objective reasonableness of that belief is not relevant.

There is no basis in law or policy, however, for applying the subjective belief standard applicable in criminal prosecutions to the "reasonable cause" requirement in civil penalty waiver cases.

To begin, in a criminal tax prosecution for willful failure to file or pay, the burden is on the government to prove the element of willfulness, which requires that the government must negate the taxpayer's claim that he had a good faith belief that he was not violating the law. The government does not have that burden in civil penalty waiver cases. To the

contrary, the burden is on the taxpayer to prove reasonable cause to waive a penalty. Code of Ala. 1975, §40-2A-11(h).

And the term "reasonable cause" itself requires that a taxpayer's good faith belief must be "reasonable." That is, an objective standard must be applied in determining if a taxpayer's failure to file a return or pay the tax due was reasonable for purposes of the §40-2A-11(h) penalty waiver statute.

Justice Blackmon dissented in *Cheek*. He argued that accepting a subjective belief standard in criminal tax evasion prosecutions would encourage taxpayers not to comply with the tax laws.

> The Court acknowledges that the conclusively established standard for willfulness under the applicable statutes is the "'voluntary, intentional violation of a known legal duty.'" (cite omitted) That being so, it is incomprehensible to me how, in this day, more than 70 years after the institution of our present federal income tax system with the passage of the Income Tax Act of 1913, 38 Stat. 166, any taxpayer of competent mentality can assert as his defense to charges of statutory willfulness the proposition that the wage he receives for his labor is not income, irrespective of a cult that says otherwise and advises the gullible to resist income tax collections. One might note in passing that this particular taxpayer, after all, was a licensed pilot for one of our major commercial airlines; he presumably was a person of at least minimum intellectual competence.
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> This Court's opinion today, I fear, will encourage taxpayers to cling to frivolous views of the law in the hope of convincing a jury of their sincerity. If that ensues, I suspect we have gone beyond the limits of common sense.

Cheek, 111 S. Ct. at 615.

Justice Blackmon's concerns apply in this and other civil penalty waiver cases. If a taxpayer's subjective but unreasonable good faith belief was sufficient to establish reasonable cause for waiver of a penalty, individuals could adopt a frivolous position

knowing that if and when caught, they might only be required to pay the tax and interest due, without penalty.

The failure to timely file and pay penalties are affirmed.[2] The frivolous appeal penalty is inapplicable, however, because the Taxpayers appealed on the advice of competent counsel. That penalty of $250 should be refunded to the Taxpayers, plus applicable interest. Judgment is entered accordingly.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 3, 2010.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
J. William Rose, Jr., Esq.
Brad S. Anderson, Esq.
Tony Griggs

[2] I note that the IRS can also impose a separate $5,000 penalty if a taxpayer files a frivolous or "protest" return. 26 U.S.C. §6702. That penalty is in addition to all other penalties that may apply. The IRS has identified various "frivolous positions" in Notice 2007-30. One such position is when a taxpayer claims that wages are not taxable income. See, Notice 2007-30(4).