In the United States Bankruptcy Court

for the Northern District of Iowa

MAURICE LEE KLEIN
Debtor(s).

Bankruptcy No. 96-12914-C
Chapter 7

MAURICE LEE KLEIN
Plaintiff(s)

vs.

STATE OF IOWA IOWA DEPARTMENT OF REVENUE AND FINANCE
Defendant(s)

Adversary No. 96-1238-C

ORDER RE: DISCHARGEABILITY OF TAXES

This matter came on for trial before the undersigned on May19, 1998 pursuant to assignment. Debtor Maurice Klein appeared with his attorney Larry Thorson. Defendant Iowa Department of Revenue and Finance ("IDOR") was represented by attorney John Waters. After the presentation of evidence and argument, the Court took the matter under advisement. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(I).

STATEMENT OF THE CASE

Debtor seeks a determination that his debt for Iowa income taxes for 1991 and 1992 are dischargeable. IDOR asserts this debt is excepted from discharge under §523(a)(1)(C). It argues Debtor made a fraudulent return with respect to these taxes or has willfully attempted to evade or defeat the taxes.

FINDINGS OF FACT

The debt at issue arises from Debtor's 1991 and 1992 Iowa income taxes. Debtor timely filed tax returns for these years. He also filed an amendment to his 1991 return. IDOR audited the returns. Adjustments resulting from the audits are shown in IDOR's Exhibits S and T. These adjustments deal with Debtor's claimed deductions. Adjustments to income were minimal, including a few dollars of interest income and some inaccuracy in reporting Federal tax refund.

For the 1991 tax year, IDOR disallowed $6,442.24 of Debtor's claimed deductions of $20,910.35. The result was additional tax due of $454.35. For the 1992 tax year, IDOR disallowed $926.72 of Debtor's claimed deductions of $6,713.55. It also disallowed approximately $5,393.48 which Debtor deducted as taxes paid. These adjustments resulted in additional tax due of $1200.77. Defective Return and False Return fines were added for both years. The audit reports for both the 1991 and 1992 tax years are dated August 1994.

Debtor testified that he listed the deductions he felt he was entitled to, relying on a portion of the Master Tax Guide which he said an IDOR agent had given to him. He did not have the help of a professional preparer. He deducted expenses such as home office expense, expenses from protesting taxes and legal expenses. Debtor stressed that he did not claim deductions which he did not feel he was entitled to and he did report all of his income.

As early as 1984, Debtor began having problems with the IDOR. His tax returns were administratively reviewed. In 1991, Debtor hired an accountant to review his 1987, 1988 and 1989 returns. He testified there were problems those years with claimed deductions. Debtor testified that he felt, however, deductions he claimed for 1991 and 1992 were acceptable.

Victor Lamb testified on behalf of the IDOR. He has been a revenue auditor for the IDOR for 23 years. He testified that he audited Debtor's taxes twice, the first time covering the 1988 and 1989 tax years. Mr. Lamb testified that Debtor did not cooperate with that audit. He failed to provide records requested. This went on for some time until Mr. Lamb requested a court order. After a show cause hearing in Iowa District Court, Debtor was held in contempt. He received a fine of $500. He paid this fine on April 19, 1991. At the completion of this audit, Debtor's 1988 and 1989 returns were found to be evasive. Debtor subsequently pleaded guilty to two counts of fraudulent practices for which he received a deferred sentence. Debtor's 1990 income tax return was prepared by a CPA and there were no problems with that return. IDOR's audit of Debtor's 1993 taxes did not result in any adjustment by the IDOR.

Mr. Lamb next audited Debtor's 1991, 1992 and 1993 returns. He testified that Debtor did not cooperate in the audit of these returns. IDOR issued a subpoena on May 2, 1994 for production of records, statements, minutes and payments. Debtor responded in a letter addressed to "Victor/Victoria W. Lamb" as follows: "[Y]ou know that there is no attorney in his right mind that would allow me to meet with you without a loaded shotgun. That's called "equal force". With or without a shotgun, you know I will not meet with you."

Once again, Debtor did not produce records or appear. Mr. Lamb requested a court order to which Debtor responded with a "Motion to Dismiss". (Defendant's Exhibit I) This document makes derogatory remarks about Mr. Lamb, the IDOR and the Court. The motion was denied and Debtor was ordered to appear before an agent of IDOR with the requested documents. The IDOR did not prosecute contempt proceedings at this point because Debtor did finally appear and produce documents and because Debtor's probation on earlier charges was being revoked. Mr. Lamb testified that the IDOR felt that there was no reason to prosecute a second contempt action or further criminal charges in these circumstances.

In August and September, 1994, IDOR completed its audit. A November 18, 1994 Notice of Assessment states taxes, penalties and interest totaling $3,177.09 were due for the 1991 and 1992 tax years. Debtor filed a protest to the notice of assessment for the 1991 and 1992 taxes, amending prior protests to include the tax years 1985 through 1993. Mr. Lamb testified that Debtor gave no valid grounds for his protest. As of July 15, 1997, Debtor owed unpaid Iowa income taxes for 1991 and 1992 totaling $1655.12 and interest totaling $722.14, with interest accruing from that date at the statutory rate.

The record contains significant information regarding Debtor's conduct in regard to the IDOR over the past decade and longer. He has made derogatory remarks about Mr. Lamb, calling him Ms. Vickie or Victor/Victoria. Debtor refers to the IDOR as "the department of nazi & gestapo". He refers to the Dubuque Assistant County Attorney as "shyster".

Debtor has continuously filed claims for refunds for millions of dollars. Recently, he claims he is entitled to $18,053,832 for tax refunds, legal expenses, penalties, 24% interest, damages for illegal confinement, and for violations of civil and constitutional rights. These claims are obviously frivolous and without merit.

Debtor has filed inconsistent W-4 forms. At different times, he has claimed zero allowances, 80 allowances or status as exempt from federal taxes on his W-4s. In 1989, Debtor was informed by the IRS that he was not allowed to deduct home office expenses. On his 1988 return, Debtor described his occupation as "tax protester" and listed his phone number as "1-800-EAT SHIT". Debtor sent an Assistant Attorney General a "gift" of Preparation H, and deducted $5.03 from his 1989 taxes for the cost of the "gift".

CONCLUSIONS OF LAW

Debtor filed this adversary proceeding seeking to have his tax debt declared dischargeable. The IDOR asserts that this debt is nondischargeable under §523(a)(1)(C). The burden of proving Debtor's tax liabilities are nondischargeable is on the IDOR. In re Pierce, 184 B.R. 338, 341 (Bankr. N.D. Iowa 1995). The IDOR must meet this burden by a

preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 285 (1991).

EVIDENCE

Debtor objected to introduction of many of IDOR's exhibits. Many of the objections are based on relevance and materiality in light of the fact that Debtor was not found in contempt of court regarding the 1991 and 1992 taxes. Debtor also objects that IDOR's exhibits relate to prior tax years and are not relevant to the tax years in issue in this case. The IDOR asserts its exhibits show Debtor's continued refusal to cooperate which is relevant to evasion of tax liability. It also asserts, among other things, that evidence of Debtor's prior conduct tends to support a finding of fraud.

The debtor in In re Birkenstock, 87 F.3d 947, 951 (7th Cir. 1996), made an argument similar to Debtor's. The court concluded:

> [T]he [debtors'] tax history was relevant to the bankruptcy court's determination of whether the [debtors] willfully attempted to avoid a known tax duty. Although an attempt to defeat tax in 1974 will not except discharge of an unpaid tax liability for 1980, the earlier conduct is relevant evidence concerning whether the debtor's actions in 1980 were the result of honest mistake or deliberate evasion.

Id.

That reasoning is equally applicable in this case. Some of the evidence offered by the IDOR herein relates to Debtor's conduct regarding taxes due in 1988 and 1989 and earlier. Debtor's complaint seeks a determination of dischargeability of taxes due in 1991 and 1992. Evidence of debtor's history with the IDOR is relevant to whether he has filed fraudulent returns or willfully evaded taxes in this proceeding. Debtor's objections to admission of this evidence are overruled.

DISCHARGEABILITY OF TAXES

The language of §523(a)(1)(C) reveals that the IDOR must prove either a willful attempt to evade payment of taxes or the making of a fraudulent return. In re Sommers, 209 B.R. 471, 481 (Bankr. N.D. Ill. 1997). In either case, the IDOR must prove that the underpayment of taxes was "deliberate" or "committed with fraudulent intent." In re Mickle, 207 B.R. 958, 962 (Bankr. M.D. Fla. 1997). If the IDOR meets its burden of proving the elements of but one of these two alternatives, it will succeed in a §523(a)(1)(C) proceeding. In re Lilley, 152 B.R. 715, 721 (Bankr. E.D. Pa. 1993). The first prong is directed solely at "tax cheats," while the second prong is also directed at "tax protesters." Id.at 722.

The first alternative for excepting tax debts from discharge under §523(a)(1)(C) arises when a debtor has willfully attempted in any manner to evade or defeat a tax. The conduct requirement of this alternative encompasses acts of culpable omission as well as acts of commission. In re Fegeley, 118 F.3d 979, 983 (3d Cir. 1997). The intent portion of tax evasion under §523(a)(1)(C) requires the government to prove the debtor voluntarily and intentionally violated a known duty to pay taxes. Id.at 984.

> The standard for willfulness in §523(a)(1)(C) is that the debtor acted voluntarily, consciously or intentionally, or with reckless disregard such as where the debtor knew or should have known that tax was due and the debtor failed to pay. The government need only show that the debtor's conduct amounts to a knowing and intentional effort to evade or defeat taxes. The standard requires that the intended result of the taxpayer's action is that the [government] not receive taxes due.

Pierce, 184 B.R. at 343 (citations omitted).

Under the second alternative, making a fraudulent return, the IDOR must establish the following elements: (1) knowledge of the falsehood of the return; (2) intent to evade the taxes; and (3) an underpayment of the tax. In re Hopkins, 133 B.R. 102, 106 (Bankr. N.D. Ohio 1991). Most courts apply the standard used in civil tax fraud cases in considering dischargeability for fraudulent tax returns. Sommers, 209 B.R. at 481. Evil motive or sinister purpose is unnecessary. Id.

BADGES OF FRAUD

Because fraud and willful evasion are rarely proven by direct evidence, they may be established by circumstantial evidence based on the debtor's conduct and inferences drawn therefrom. Hopkins, 133 B.R. at 106; In re Toti, 24 F.3d 806, 809 (6th Cir.), cert. denied, 513 U.S. 987 (1994); In re Burgess, 199 B.R. 201, 206 (Bankr. N.D. Ala. 1996). Courts rely on badges of fraud, including understating income, failing to keep adequate records, failing to file tax returns, failing to cooperate with audits, concealing assets or income, and implausible or inconsistent behavior by the taxpayer. Hopkins, 133 B.R. at 106; In re Irvine, 163 B.R. 983, 986 (Bankr. E.D. Pa. 1994); In re Teeslink, 165 B.R. 708, 716 (Bankr. S.D. Ga. 1994).

Overstatement of deductions has also been cited as a badge of fraud under §523(a)(1)(C). In re Brackin, 148 B.R. 953, 957 (Bankr. N.D. Ala. 1992) (stating government primarily based allegations of fraud on unreported and illegal deductions). The court in Lilley found a badge of fraud present in the debtor's large attempted deductions over time. 152 B.R. at 722 n.7. In In re Harris, 59 B.R. 545, 548 (Bankr. W.D. Va. 1986), the court found the debtor included two fraudulent items, a fictitious exemption and related child care expenses. It concluded the tax return was therefore fraudulent and the related tax debt was excepted from discharge. Id. In In re Ketchum, 177 B.R. 628, 632 (E.D. Mo. 1995), filing false W-4 withholding statements so employers would withhold no money for taxes, combined with failing to file tax returns or to pay tax liability established willful evasion under §523(a)(1)(C).

CONCLUSIONS

The Court concludes that the record supports a finding that Debtor acted deliberately and with intent to avoid a known tax duty in preparing his 1991 and 1992 Iowa income tax returns. Debtor was essentially accurate in reporting his income. That fact, however, is not determinative in considering dischargeability under §523(a)(1)(C). Many badges of fraud are proven in the record which indicate Debtor's fraudulent intent.

Debtor continuously refused to cooperate with the IDOR's requests for information. His responses to IDOR's requests were derogatory and inflammatory. He finally did turn over information about his 1991 and 1992 taxes after the IDOR requested a court order. The fact that Debtor was not prosecuted for contempt at that time was due to the fact that Debtor's probation on earlier criminal tax charges was revoked, not because Debtor was cooperative. Debtor also filed a frivolous appeal of the adjustments.

The adjustments IDOR made to Debtor's 1991 and 1992 taxes arose mostly from overstatements of deductions. Debtor's 1988 and 1989 taxes were also adjusted for overstatement of deductions. The record indicates that Debtor attempted to take deductions in 1991 and 1992 which were similar in nature to deductions which the IDOR and the IRS refused to allow in earlier years. Debtor must have been aware these deductions were not allowed. His 1990 tax return, prepared by an accountant, was not problematic, nor was his 1993 return.

Debtor exhibited inconsistent behavior in changing his claims for allowances on W-4 forms. He exhibits implausible behavior by continually requesting refunds of millions of dollars. Furthermore, the tenor of his correspondence, making derogatory comments about revenue officers and government attorneys, supports a finding that his intent is that the IDOR not receive taxes due.

The Court concludes that Debtor willfully attempted to evade 1991 and 1992 taxes. He knowingly took deductions to which he was not entitled in order to reduce taxes. The IDOR has also proven that Debtor made fraudulent returns for the 1991 and 1992 tax years. Debtor knew the claimed deductions were improper and he intended to evade taxes by wrongfully reducing the amount of his taxable income. The effect of these claims of deductions was that Debtor underpaid his taxes.

WHEREFORE, Debtor's Complaint to Determine Dischargeability of a Debt is DENIED.

FURTHER, Debtor's 1991 and 1992 Iowa income taxes are nondischargeable under 11 U.S.C. §523(a)(1)(C).

FURTHER, judgment shall enter accordingly.

SO ORDERED this 15 day of June, 1998.

PAUL J. KILBURG

Paul J. Kilburg
U.S. Bankruptcy Judge