No. 19-71432

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PEYMON MOTTAHEDEH,

Petitioner-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ON APPEAL FROM THE ORDER AND DECISION
OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF JURISDICTION

On June 27, 2011, the Commissioner of Internal Revenue mailed a notice of deficiency pursuant to § 6212 of the Internal Revenue Code of 1986 (26 U.S.C.) (I.R.C.) to Peymon Mottahedeh (2-SER-117-168)[1]

[1] "SER" references are to the volumes and pages of the excerpts of record filed by the appellee with this brief. "Doc." references are to the documents in the record on appeal, as numbered by the Clerk of the Tax Court. "Ex." references are to the exhibits submitted with the stipulation of facts or at trial.

and another notice of deficiency to his wife, April Mottahedeh ("taxpayers") (2-SER-169-214), asserting income tax deficiencies and penalties for 2001 through 2006. Taxpayers filed a timely joint Tax Court petition on September 26, 2011, contesting the deficiencies and penalties. *See* I.R.C. § 6213(a). (3-SER-308-309.) Taxpayers resided in California at that time. (1-SER-9; 3-SER-309.) The Tax Court had jurisdiction under I.R.C. §§ 6213(a) and 7442.

The Tax Court entered an order and decision upholding the deficiency on January 28, 2015. (1-SER-4-5.) The Tax Court's decision finally disposed of all claims of all parties and is final and appealable. The Tax Court denied taxpayers' timely (because of extensions granted) motion to vacate or revise the decision on November 26, 2018. (1-SER-2; 3-SER-322-324.) Taxpayers timely mailed separate notices of appeal to the Eleventh Circuit on February 23, 2019. (3-SER-310-311); I.R.C. §§ 7483, 7502; Fed. R. App. P. 13(a)(1)(B).

On June 7, 2019, the Eleventh Circuit transferred the appeal to this Court, where venue properly lies. *See* 26 U.S.C. § 7482(b)(1)(G); 28 U.S.C. § 41. This Court has jurisdiction under I.R.C. § 7482(a)(1).

STATEMENT OF THE ISSUES

1. Whether the Tax Court's finding that taxpayers had unreported income in at least the amounts determined by the IRS is clearly erroneous.

2. Whether the Tax Court's finding that taxpayers are liable for the penalties is clearly erroneous.

APPLICABLE STATUTES AND REGULATIONS

This case does not involve any statutes, regulations, or other authorities that are specifically at issue or that are not commonly known. *See* Fed. R. App. P. 28(f); 9th Cir. R. 28-2.7.

STATEMENT OF THE CASE

Taxpayers, who failed to file returns for 2001 through 2006, filed a Tax Court petition challenging notices of deficiency asserting income and self-employment tax deficiencies and penalties against them for those years. A trial was held at which taxpayers offered no evidence and the IRS Revenue Agent who conducted the audit testified in detail about the method used to reconstruct their unreported income. After the trial, the Tax Court issued a memorandum opinion and an order and decision finding that the preponderance of the evidence favored the IRS. Taxpayers now appeal.

1. Statement of facts

a. Taxpayers' business activities

Peymon Mottahedeh, with the assistance of his wife, April Mottahedeh, runs Freedom Law School. (1-SER-10.) According to the school, "[t]here is no statute that makes any American Citizen, who works for a living in the United States of America, liable or responsible to pay the income tax." (2-SER-243.) Through the school, taxpayers promote a tax-avoidance scheme. They urge their students to (1) refuse to file tax returns or provide any information to the IRS and (2) argue that the IRS bears the burden of proving the amount of their unreported income. (2-SER-232-239, 243-249; *see* Doc. 21, Exs. 12-J, 14-J, 15-J, 16-J.)

The school teaches that taxpayers need not comply with the recordkeeping requirements imposed by the Internal Revenue Code and Treasury Regulations (2-SER-247):

> It is a lot of work and expense to keep such good records of your receipts, canceled checks and note taking necessary to help you remember the explanation of ALL of your expenses and deductions. It forces a businessman to keep a much more elaborate and complicated record and bookkeeping system than what he would need for his own business needs.

The school further teaches that tax-return filing is voluntary (2-SER-246):

> Why are filers so EASY to RAPE and ABUSE by the IRS? Because these misinformed people, by VOLUNTARILY filling out a 1040 Income Tax Confession form had given the IRS the full laundry list of everything they own, so that the IRS knows WHERE to go to steal their victim's wealth and assets.

The school instructs a taxpayer facing an IRS audit to resist because "ALL records can and will be used against you." (2-SER-294; *see* 2-SER-231-238.)

The school preaches that compliance with the tax laws is disadvantageous (2-SER-232):

> If you are a sucker, in love with your IRS agent, think the government will never trick you, or uninformed of your natural rights and the restrictions of the 5th Amendment on the government, you can exercise your natural right of free speech as protected by the 1st Amendment, and blabber about yourself and place the rope around your own neck, **voluntarily.**

The school asserts that a taxpayer gains a strategic advantage by not complying with the tax laws because, according to the school, the taxpayer thereby shifts the burden of proof to the IRS: "FOR NON-FILERS, THE BURDEN OF PROOF IS ON THE IRS. HALLELUAH, FREE AT LAST!" (2-SER-247.) The school explains

that, in its view, the IRS's burden of proof in that situation would be quite difficult (2-SER-248):

> If the aware citizen did not hang himself by confessing to earnings from employers or other third parties, the IRS agents would actually have to work and conduct a full investigation in order to find witnesses who could testify that he had actually worked or performed services for the third party payers. Additionally, the IRS would have to bring to court the original of ALL the cancelled checks that would back up the IRS' claims against you. Do you think this is easy for the IRS to do?

The school earns income from fees for conferences and sales of instructional materials. (2-SER-55-57, 224, 230, 243-244, 265, 271, 276, 286, 293, 297-298, 300-301.) It also sells packages of services, including the "Simple Freedom Package" for an initial fee of $4,000 and the "Royal Freedom Package" for an initial fee of $6,000. (2-SER-297.) In addition, Freedom Law School sells memberships in its multilevel marketing arrangement, which entitle the member to recruit new members and to share in the profits generated by the recruits. (2-SER-298-299.)

Taxpayers apply the scheme that they promote. (1-SER-12.) They do not file tax returns. They do not provide business records or any other relevant information to the IRS. (1-SER-12.) They avoid banks.

(1-SER-12; 2-SER-218, 294.) They request their customers to pay in cash. (1-SER-12; 2-SER-218, 220, 224, 230, 244, 287, 293-294, 299-300.)

Peymon, through Freedom Law School, also represented taxpayers before the California Franchise Tax Board, charging a fee payable in cash. (1-SER-19; 2-SER-60, 219-220; *see* Doc. 21, Ex. 19-J at 5.)

b. The audit and notice of deficiency

Since taxpayers deliberately concealed their business records and avoided financial institutions to avoid leaving an audit trail, the IRS resorted to an indirect method of estimating their unreported income. (1-SER-14-15, 22-24.) The IRS ultimately determined the amount of their unreported income by estimating that taxpayers' income is at least equal to their expenses. (1-SER-23-24.) The IRS Agent conducting the audit thus began with cost-of-living expenditure estimates published by the Bureau of Labor Statistics, and then modified those figures using actual transactions that the Revenue Agent was able to document. (1-SER-25.) The IRS determined that taxpayers had aggregate unreported income of $44,757 for 2001, $61,536 for 2002, $69,653

for 2003, $66,924 for 2004, $56,850 for 2005, and $83,629 for 2006. (1-SER-8, 15-16; 2-SER-121, 123; *see* Doc. 21, Ex. 20-J.) The IRS allocated one-half of the unreported income to each spouse, in accordance with California community-property laws, and asserted self-employment tax deficiencies against Peymon (but not April). (1-SER-15-16; 2-SER-121, 123, 162, 173, 175, 177.) In addition, the IRS determined that April had separate wage income in 2001 of $11,469. (1-SER-15; 2-SER-177)

Following the audit, the IRS issued separate notices of deficiency to Peymon and April, asserting the following deficiencies and penalties (1-SER-7; 2-SER-117-214):

			Penalties		
		Deficiency	§ 6651(a)(1)	§ 6651(a)(2)	§ 6654
2001	Peymon	$8,203	$1,846	$2,051	$328
	April	4,634	1,043	1,159	185
2002	Peymon	11,316	2,546	2,829	378
	April	3,331	749	833	111
2003	Peymon	12,811	2,882	3,203	331
	April	3,704	833	926	-0-
2004	Peymon	12,215	2,748	3,054	350
	April	3,471	781	868	-0-

2005	Peymon	10,102	2,273	2,526	405
	April	2,669	601	668	107
2006	Peymon	15,560	3,501	3,890	736
	April	4,901	1,103	1,225	232

Taxpayers filed a joint Tax Court petition contesting the deficiencies, but they did not contest the penalties. (3-SER-308-309.)

c. The Tax Court trial

In the Tax Court, taxpayers did not offer any evidence relevant to the determination of their correct taxable income, but rather invoked the Fifth Amendment privilege against self-incrimination in response to questions about their finances. (*See* Doc. 30 at 133-140.) Instead, they complained about the nature of the audit proceedings, argued that the IRS had the burden of proof, and argued that the unreported income was not community property. (3-SER-308-309; *see* Docs. 60, 61.)

At trial, a former customer testified that he paid Freedom Law School $130 to attend one of its conferences. (2-SER-55-57; *see* Ex. 12-J at 51.) The IRS submitted copies of checks and money orders from customers of Freedom Law School that were deposited into April's credit union account. (1-SER-18; *see* Doc. 21, Ex. 12-J.)

A former client of Peymon's testified that he paid Peymon $22,000 in cash to represent him in a case before the California Franchise Tax Board. (2-SER-59-60.) The IRS submitted copies of official announcements of the hearings before the California Franchise Board in which taxpayer was listed as the representative of several other taxpayers. (1-SER-19; *see* Doc. 21, Ex. 19-J.)

Agent Thai testified about the method she used to reconstruct taxpayers' unreported income. (2-SER-61-90.) She is an experienced accountant who has been employed as an IRS Revenue Agent since 1995. (2-SER-62.)

Agent Thai approached this case in accordance with established procedures for non-filers, which meant she first sent taxpayers a letter scheduling a meeting to discuss their failure to file returns for 2001-2006. (2-SER-62-63.) Taxpayers failed to appear. (2-SER-63.) Upon learning that Freedom Law School held a seminar at a hotel, she issued a summons to taxpayers seeking documentation of the entrance fees received. (2-SER-63.) Taxpayers failed to comply. (2-SER-64.) Instead, taxpayers sent a letter to Agent Thai stating that she would comply with the summons only if she first answered a list

of 36 "questions." (2-SER-64, 93-101.) Agent Thai then served a document request upon taxpayers, requesting tax returns and supporting documentation such as bank statements and payroll records. (2-SER-64-65.) Taxpayers failed to comply. (2-SER-65.)

Next, she served third-party summonses on a bank with which she had reason to believe they did business and hotels at which Freedom Law School held seminars, seeking information regarding taxpayers' business activities. (2-SER-65.) Taxpayers, unsuccessfully, filed petitions to quash the summonses in district court. (2-SER-65-66.) Agent Thai received documentation from the third parties pursuant to the summonses. (2-SER-66.) Although the hotel records were not helpful in determining amounts of income, they confirmed that Freedom Law School was collecting cash entrance fees for its conferences. (2-SER-66; *see* Doc. 21, Ex. 14-J.) The bank records, including canceled checks, revealed that April received payments made to Freedom Law School for entrance fees and instructional materials, which she deposited into her bank account. (2-SER-67; *see* Doc. 21, Ex. 12-J.) The bank records alone were not adequate to reconstruct

taxpayer's unreported income because only a fraction of taxpayers' money entered the banking system. (2-SER-68-69.)

Agent Thai determined that the absence of records from taxpayers and the incomplete information obtained pursuant to the summonses required that she resort to cost-of-living expenditure estimates published by the Bureau of Labor Statistics ("BLS") to estimate taxpayers' unreported income. (2-SER-69; *see* Doc. 21, Ex. 20-J.) For 2001 and 2002, Agent Thai used BLS figures for a family of four, including April's two children from her prior marriage. (2-SER-69; *see* Doc. 21, Ex. 20-J at 2, 6.) For 2003 through 2006, she used BLS figures for a family of five because Peymon and April had a child in 2003. (2-SER-69; *see* Doc. 21, Ex. 20-J at 14, 18, 22.) She determined that April received wages in 2001, but that she had no other income of her own during the other years. (2-SER-70-71; see Doc. 21, Ex. 20-J at 25.) Except for that income, April primarily assisted Peymon in operating Freedom Law School. (2-SER-70-71.) Agent Thai thus used BLS figures for a family with one wage-earner. (2-SER-70; *see* Doc. 21, Ex. 20-J at 2, 6, 14, 18, 22.)

Agent Thai modified the BLS housing data to reflect actual transactions that she was able to identify. (2-SER-71-80.) For 2001, for example, she replaced the BLS estimates with $6,002 as taxpayers' actual mortgage expense based on documentation regarding a mortgage with Wells Fargo for part of the year, and $7,427 as rental expense for the part of the year before the home was purchased. (2-SER-71-74; *see* Doc. 21, Ex. 20-J at 3, 25.) For 2002, Agent Thai substituted $14,487 documented mortgage expense for the BLS estimate for housing expense, and she added actual documented payments to an individual, a credit card company for home maintenance and repairs, utilities and telephone bills. (2-SER-79-82; *see* Doc. 21, Ex. 20-J at 7, 28, 40-41.) For 2003, Agent Thai substituted $14,951 documented mortgage expense for the BLS estimate for housing expense, and she added actual documented payments to a credit card company for home maintenance and repairs, utilities telephone bills, and fees paid by Peymon for a potential run for Congress. (2-SER-84-86; *see* Doc. 21, Ex. 20-J at 11, 29-32, 41-42.) For 2004, Agent Thai substituted $15,783 documented mortgage expense for the BLS estimate for housing expense, and she added actual documented payments to credit card

companies for home maintenance and repairs. (2-SER-86-87; *see* Doc. 21, Ex. 20-J at 11, 32-34.) For 2005, Agent Thai substituted $15,080 documented mortgage expense for the BLS estimate for housing expense and she substituted $3,569 utilities expense for $3,142 BLS estimate for utilities. (2-SER-87-88; *see* Doc. 21, Ex. 20-J at 19, 34-35, 42-43.) For 2006, Agent Thai substituted $20,552 documented mortgage expense for the BLS estimate for housing expense, she substituted $5,580 utilities expense for $3,550 BLS estimate for utilities, and she added amounts of various loan payments made. (2-SER-88-90; *see* Doc. 21, Ex. 20-J at 23, 36-39, 43.)

2. The Tax Court's opinion and decision

The Tax Court concluded that taxpayers earned at least the amount of income the IRS ascribed to them and the Tax Court thus redetermined the same tax deficiencies. (1-SER-4-25.) The court explained that, in a case involving unreported income, the IRS "must build a minimal evidentiary foundation that links the taxpayer to the alleged income-producing activities." (1-SER-17 (citing *Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979).) The court determined that Peymon founded Freedom Law School and was its president and

that April arranged conferences and handled finances for Freedom Law School. (1-SER-18.) The court also found that Peymon represented clients before the California Franchise Tax Board and that April also participated in that state tax practice. (1-SER-18-19.) The court thus determined that the IRS established the requisite link between taxpayers and the income-producing activities. (1-SER-19.)

The Tax Court next considered whether the income amounts that the IRS determined were supported by a preponderance of the evidence and found that they were. (1-SER-20-23.) As a preliminary matter, the Tax Court noted taxpayers' argument that they fall within the I.R.C. § 7491(b) exception to the general rule that taxpayers bear the burden of proof regarding determinations in the notice of deficiency. (1-SER-20 n.13.) But the court explained that it need not decide that issue because it resolved the factual issues in the IRS's favor "based on a preponderance of evidence." (*Id.*) The court explained that its finding that the IRS determined the correct income amounts "are supported by three types of evidence": (1) evidence of direct payments taxpayers received, such as the $22,000 a client paid and payments from Freedom Law School customers deposited into April's credit-union account;

(2) evidence that taxpayers avoided banks and records and thus that the amounts established by direct evidence "are but a fraction" of taxpayers' total income; and (3) the fact that taxpayers "had personal living expenses that must have been paid from some source." (1-SER-22-23.)

The Tax Court rejected taxpayers' argument that the IRS should be limited to direct evidence. (1-SER-23.) It explained that taxpayers avoided banks and that even the bank record the IRS was able to obtain were incomplete. (*Id.*) It thus concluded that attempting to reconstruct taxpayers' income based on bank records "would underestimate" taxpayers' income. (*Id.*)

The court determined that the IRS's "use of average spending statistics supplemented by estimates of actual spending amounts" was appropriate. (1-SER-23-24.) It explained that courts have upheld the IRS's use of average spending statistics where "as here, the taxpayer fails to cooperate with the IRS." (*Id.* (*citing Palmer v. United States*, 116 F.3d 1309 (9th Cir. 1997) and other cases.) The court also rejected taxpayers' arguments about how the IRS used the statistics. It explained that the 37% increase in taxpayers' estimated spending from

2001 to 2002 was on account of alterations in the numbers based on evidence of taxpayers' actual spending. The court concluded that the IRS's method of relying partly on statistics from the Bureau of Labor Statistic and partly on direct estimates of spending "was a permissible method of estimating [taxpayers'] spending." (1-SER-25.)

The court further found that the unreported income was community property, one-half of which was properly allocated to April. (1-SER-26-29.) Although April had executed an agreement disclaiming any community-property right to income earned by taxpayer through his "own labor and/or initiative," the court found the unreported income was generated by the couple's joint efforts and thus is not covered by the agreement. (1-SER-29.)

The court also sustained the penalties because taxpayers failed to file returns or to pay the tax and required estimated taxes, and taxpayers did not argue that they were entitled to any exceptions to the penalties. (1-SER-29-34.) The court accordingly entered a decision sustaining the deficiencies and penalties. (1-SER-4-5.)

SUMMARY OF ARGUMENT

1. Taxpayers run Freedom Law School, which teaches that a taxpayer can prevail against the IRS by violating the tax laws, because a failure to comply with the recordkeeping and return-filing requirements of the Internal Revenue Code and Treasury Regulations allegedly prevents the IRS from determining a tax liability. Taxpayers unsuccessfully applied that strategy here, concealing their records from the IRS and the Tax Court and arguing that the IRS cannot prove their correct taxable income without those records. The Tax Court correctly rejected this meritless argument.

The law requires a taxpayer to maintain accounting records sufficient to permit determination and verification of his correct tax liability, and to provide such records to the IRS upon request. It is well settled that, where a taxpayer fails or refuses to comply with these requirements, the IRS may use any reasonable means to estimate unreported income. Where the IRS meets its burden of connecting the taxpayer to an income-producing activity, the taxpayer bears the burden of proving that the IRS's estimates are excessive.

Thus, a taxpayer cannot prevail simply by refusing to comply with the tax laws and then attempting to "put the IRS on trial" in the Tax Court. Where, as here, the IRS credibly demonstrates that it had to resort to an indirect method to estimate the taxpayer's income because the taxpayer supplied no records, and that the method it used to estimate the unreported income was reasonable, and the taxpayer continues to offer no evidence of his income, it follows that the preponderance of the evidence favors the IRS. The Tax Court's finding that taxpayers received unreported income of at least the amounts determined by the Commissioner is not clearly erroneous.

2. The Tax Court also correctly sustained the penalties imposed in the notice of deficiency. The facts demonstrate that the penalties are applicable, and taxpayers do not allege that any exception applies.

The order and decision of the Tax Court is correct and should be affirmed.

ARGUMENT

I

The Tax Court correctly found that the IRS's reconstruction of taxpayers' unreported income was reasonable under the circumstances

Standard of review

The Tax Court's finding that taxpayers had income of at least the amounts determined by the IRS is reviewed for clear error. *Edelson v. Commissioner*, 829 F.2d 828, 831 (9th Cir. 1987); *Weimerskirch v. Commissioner*, 596 F.2d 358, 360 (9th Cir. 1979).

A. The applicable legal framework

The law requires a taxpayer to maintain accounting records sufficient to permit determination and verification of his correct tax liability, and to provide such records to the IRS upon request. I.R.C. § 6001; Treas. Reg. § 1.6001-1(a),(e) (26 U.S.C.); *Palmer v. IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997); *Cracchiola v. Commissioner*, 643 F.2d 1383, 1385 (9th Cir. 1981). Where a taxpayer fails or refuses to comply with these requirements, the IRS must resort to indirect methods to reconstruct his income. In that situation, the taxpayer's tax liability may be computed by any reasonable means, and the IRS has wide discretion in choosing the appropriate method for doing so.

I.R.C. § 446(b); *Choi v. Commissioner*, 379 F.3d 638, 640 (9th Cir. 2004); *Palmer*, 116 F.3d at 1312; *Cracchiola*, 643 F.2d at 1385; *Anaya v. Commissioner*, 983 F.2d 186, 188 (10th Cir. 1993); *Pollard v. Commissioner*, 786 F.2d 1063, 1066 (11th Cir. 1986); *Giddio v. Commissioner*, 54 T.C. 1530, 1533 (1970).

The figures derived by an indirect reconstruction of a taxpayer's income are necessarily estimates. *Page v. Commissioner*, 58 F.3d 1342, 1347 (8th Cir. 1995) (non-compliant taxpayer may not complain that IRS's estimates are imprecise); *Jones v. Commissioner*, 903 F.2d 1301, 1303 (10th Cir. 1990) ("a taxpayer who has abandoned the advantage of mathematical precision by failing to keep adequate records cannot complain that the Commissioner's assessment is based on estimates rather than proven amounts of unreported income."); *Schroeder v. Commissioner*, 291 F.2d 649, 653 (8th Cir. 1961) ("the fact finder is warranted in bearing heavily against the contentions of the taxpayer whose inexactitude is of his own making"); *Camprise v. Commissioner*, T.C. Memo. 1980-130, 40 T.C.M. (CCH) 211, 217 (1980) (non-compliant taxpayers are not at liberty to "to condemn [the IRS] for an inexactitude of their own making").

The Commissioner's determination of a deficiency based on unreported income is entitled to a presumption of correctness if evidence links the taxpayer to an income-generating activity and the method used to reconstruct the taxpayer's income is rational. *Palmer*, 116 F.3d at 1312; *Edelson*, 829 F.2d at 831; *Pollard*, 786 F.2d at 1066; *Rapp v. Commissioner*, 774 F.2d 932, 935 (9th Cir. 1985); *Delaney v. Commissioner*, 743 F.2d 670, 671 (9th Cir. 1984); *Keogh v. Commissioner*, 713 F.2d 496, 501 (9th Cir. 1983); *Edwards v. Commissioner*, 680 F.2d 1268, 1270 (9th Cir. 1982); *Cracchiola*, 643 F.2d at 1385; *Weimerskirch*, 596 F.2d at 360-62. Where those requirements are met, the taxpayer bears the burden of proving, by a preponderance of the evidence, that the deficiency is excessive. *Helvering v. Taylor*, 293 U.S. 507, 515-16 (1935); *Palmer*, 116 F.3d at 1312; *Edelson*, 829 F.2d at 831; *Delaney*, 43 F.2d at 671; *Keogh*, 713 F.2d at 501; *Cracchiola*, 643 F.2d at 1385; *Pollard*, 786 F.2d at 1066.

B. Taxpayers contend that by avoiding banks, not filing returns, and not cooperating with the audit they foil the IRS's effort to tax them

Through their business, Freedom Law School, taxpayers teach that one can gain a strategic advantage and shift the burden of proof to the IRS merely by violating the tax laws. According to this tax-avoidance scheme, a taxpayer can prevent the IRS from meeting its burden by refusing to comply and thereby denying the IRS access to records establishing the taxpayer's income. Taxpayers tested that tax-avoidance scheme in this case. It failed.

The core premise of the tax-avoidance scheme taxpayers sold to others and tried to use themselves is that the IRS is powerless to assess income tax without direct evidence of income. But that premise conflicts with overwhelming authority. As explained above (p. 20), the IRS has broad discretion to estimate income when taxpayers refuse to provide the information they are required to provide. And, as the Tax Court noted (1-SER-24), this Court explained in *Palmer* that "[c]ourts have long held that the IRS may rationally use statistics to reconstruct income where taxpayers fail to offer accurate records," specifically identifying "cost-of-living statistics for a particular locale"

as a reasonable use of statistics. 116 F.3d at 1312. This Court, in *Palmer*, also explained that the use of statistics falls within the IRS's "wide discretion in choosing an income-reconstruction method" and that, so long as the "method of calculating income is rationally based, courts afford a presumption of correctness to the Commissioner's determination." *Id.* *Palmer* thus confirms that the IRS can use the method it used here to estimate income and that – notwithstanding taxpayers' contrary assertion – using that method does not shift the burden of proof.

In *Bradford v. Commissioner*, 796 F.2d 303, 306 (9th Cir. 1986), this Court dealt with a situation like this one: "where the taxpayer kept inadequate records or no records at all, and then relied mainly on testimony to challenge the Commissioner's reconstruction of income." This Court rejected this turn-the-tables-on-the-IRS strategy, approved the IRS's use of statistical evidence to reconstruct income, and determined that the "Tax Court's finding that [the taxpayer] had failed to show that the Commissioner's assessment was unreasonable was not clearly erroneous." *Id.* at 306-07 (citing cases).

Indeed, to hold otherwise "would be tantamount to holding that skillful concealment of income by failure to keep records . . . from which income could be reconstructed would be an invincible barrier to proof." *Keogh*, 713 F.2d at 502. *See also United States v. Johnson*, 319 U.S. 503, 517-18 (1943) (same); *Adamson v. Commissioner*, 745 F.2d 541, 548 (9th Cir. 1984) ("[T]he taxpayer should not be allowed to avoid paying taxes simply because he keeps incomplete records."); *Dark v. United States*, 641 F.2d 805, 808 (9th Cir. 1981) (argument that conspicuous absence of business records immunizes taxpayer from tax liability "lacks support in precedent or reason"). Taxpayers' scheme flies in the face of this overwhelming authority.

C. The Tax Court's finding that the evidentiary scale tips strongly in favor of the IRS is not clearly erroneous

The Tax Court correctly found that the IRS secured the benefit of the presumption of correctness by connecting taxpayers to income-producing activities, namely, Freedom Law School and practice before the California Franchise Tax Board. (1-SER-17-19.) The court further correctly found that the IRS submitted credible testimony of Revenue

Agent Thai that she had to resort to BLS data because taxpayers went to great lengths to conceal their financial information.[2] (1-SER-20-22.) As taxpayers explain it, they do "not make use of the services of typical financial institutions" because "[w]e realize that ALL records can and will be used against you." (2-SER-294.) Agent Thai further credibly testified in detail about her efforts to estimate taxpayers' unreported income starting with BLS data and then modifying those numbers with the information she did obtain about taxpayers' finances. (2-SER-51-90.)

Taxpayers, on the other hand, offered no evidence that their correct taxable income was lower than the amounts determined by the IRS. On this lopsided record, the Tax Court's finding that the preponderance of the evidence supported the IRS is not clearly erroneous, but rather is clearly correct. *See Anderson v. City of Bessemer City, North Carolina*, 470 U.S. 564, 573-74 (1985) (trial court's

[2] The use of BLS statistics (sometimes, as here, modified using known actual expenses) has been approved in other unreported income cases. *See Hanel v. Commissioner*, 6 F. App'x 452, 453 (7th Cir. 2001) (evidence supported IRS's determination of unreported income where Revenue Agent credibly testified about her method of using BLS data modified by actual documented expenses and taxpayers offered noting); *Pollard*, 786 F.2d at 1066; *Giddio*, 54 T.C. at 1532-33.

finding is not clearly erroneous if it is within the range of plausible conclusions that could reasonably have been drawn from the evidence); *Wolf v. Commissioner*, 4 F.3d 709, 712-13 (9th Cir. 1993).

D. Peymon's arguments are meritless

1. Consistent with the scheme promoted by Freedom Law School and followed by taxpayers, Peymon attempts to deflect the burden of proof to the IRS. (Br. 11-12.) As the Tax Court correctly held, however, the burden of proof cannot help him here. (1-SER-20 n.13.) The burden of proof is determinative only in a case where the evidence is in equipoise. *Polack v. Commissioner*, 366 F.3d 608, 613 (8th Cir. 2004) ("a shift in the burden of preponderance has real significance only in the rare event of an evidentiary tie"); *Dubisky v. Commissioner*, 62 F.3d 182, 185 (7th Cir. 1995); *Brinkley v. Commissioner*, 808 F.3d 657, 664 (5th Cir. 2015); *Scheidelman v. Commissioner*, 755 F.3d 148, 154 (2d Cir. 2014); *Esgar Corp. v. Commissioner*, 744 F.3d 648, 654 (10th Cir. 2014). As the Tax Court correctly found, however, this case was not a close one. The IRS's credible showing of the method used to reconstruct taxpayers' unreported income, balanced against the

evidentiary void on taxpayers' side, tipped the scale strongly in favor of the IRS.

Even if the burden of proof mattered here, I.R.C. § 7491(b) did not impose the burden on the IRS. Section 7491(b) provides that "the Secretary shall have the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary *solely* through the use of statistical information on unrelated taxpayers." (Emphasis added.) Here, the IRS did *not* rely *solely* on BLS data, but rather modified the data to reflect actual transactions for which documentary evidence was obtained.

2. Having failed to turn the tables on the IRS, Peymon seeks to cut his losses by limiting his income to the bank deposits that the IRS was able to unearth. (Br. 13-19.) But the choice of the most appropriate method of reconstructing unreported income lies with the IRS, not the non-compliant taxpayer. *Choi*, 379 F.3d at 640; *Palmer*, 116 F.3d at 1312; *Cracchiola*, 643 F.2d at 1385; *Anaya*, 983 F.2d at 188; *Pollard*, 786 F.2d at 1066; *Giddio*, 54 T.C. at 1533. No doubt, taxpayers' preferred method would play into their scheme, as the Tax Court aptly observed (1-SER-23):

> the Mottahedehs tried to avoid the use of banks. Their bank records would not provide sufficient information about their income. Furthermore, even the bank records that the revenue agent obtained were incomplete. The revenue agent was unable to obtain records of all of the deposits to the Mottahedehs' accounts. For these reasons, focusing exclusively on the income reflected in their bank records would underestimate the Mottahedehs' income.

(*See* 2-SER-294) ("FLS does not make use of the services of typical financial institutions" because "[w]e realize that ALL records can and will be used against you.").)[3]

3. Peymon's contention that he has cooperated with the IRS (Br. 32-33) cannot be taken seriously. He filed no returns, provided no business records, and offered no relevant evidence in the Tax Court. He argues that the audit infringed his due process rights and blames the IRS for his non-compliance. (Br. 19-33.) These objections to the audit are irrelevant. When a taxpayer petitions the Tax Court for redetermination of a deficiency, the court's jurisdiction is generally limited to determining the correct amount of the taxpayer's liability

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[3] Peymon asserts (Br. 16-17) that taxpayers' bank records established income higher than the auditor recognized. Even if this were true, it would not undermine the Tax Court's finding that, given taxpayers' avoidance of banks and the fact that the IRS was not able to obtain complete bank records, the IRS could not reliably estimate income using bank records.

by weighing the evidence before it. I.R.C. §§ 6213(a), 7442. A trial before the Tax Court is a *de novo* proceeding. *Clapp v. Commissioner*, 875 F.2d 1396, 1403 (9th Cir. 1989). As a result, the Tax Court's "determination as to a petitioner's tax liability must be based on the merits of the case and not on any previous record developed at the administrative level." *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 328 (1974). As general rule, therefore, the Tax Court does not look behind a notice of deficiency to consider the audit activities. *Clapp*, 875 F.2d at 1403; *Raheja v. Commissioner*, 725 F.2d 64, 67 (7th Cir. 1984). Taxpayer exercised his due process rights by taking advantage of the opportunity to be heard at trial in the Tax Court, and he has no one to blame but himself for his failure of proof.

4. To the extent that Peymon is contending that the IRS did not establish the failure to offer accurate records necessary to justify resorting to statistical reconstruction of income (Br. 32-33; *see also Palmer*, 116 F.3d at 1312), that argument likewise fails. As the Tax Court explained, the IRS agent assigned to the audit: invited taxpayers to meet with her; then served them with summonses requiring them to bring relevant information to her; then received a letter from taxpayers

stating "that they would comply with the summonses only if the revenue agent answered 36 questions set forth in the letter"; also called Peymon after taxpayers failed to comply with the summons and left a message; sent a written request for records of Peymon's business activities that he failed to respond to; and "sought information from various parties with whom [taxpayers] did business." (1-SER-12-14.) Because of taxpayers' noncooperation, the IRS agent "was unable to get enough information to directly determine the amounts of [taxpayers'] income." (1-SER-14-15.) And "[c]onsequently, [the IRS agent] determined their income by assuming that their annual income was equal to their annual spending" and determined spending using statistics along with direct evidence. (1-SER-15.) The Tax Court's findings establish beyond any doubt that this is a case in which taxpayers "fail[ed] to offer accurate records." *See Palmer*, 116 F.3d at 1312.

Even supposing (contrary to the record evidence) that taxpayers did not have sufficient opportunity to proffer evidence of their income during the audit process, they could have proffered such evidence in the Tax Court. If they had, the Tax Court could have assessed its

credibility and, if such evidence were credible, used it to redetermine their tax liability. But taxpayers did not proffer any evidence and so the Tax Court could only determine whether the IRS's reconstruction of their income was reasonable under the circumstances. The Tax Court found that it was. And that finding is most certainly not clearly erroneous.

II

The Tax Court correctly found that taxpayers are liable for penalties for failure to file returns and to pay taxes and failure to pay estimated taxes

Standard of review

The Tax Court's finding that taxpayer is liable for penalties is reviewed for clear error. *Hansen v. Commissioner*, 820 F.2d 1464, 1469 (9th Cir. 1987).

In their petition, taxpayers did not contest the penalties set forth in the notice of deficiency. (3-SER-308-309.) Taxpayers thereby conceded the penalties. *See* Tax Ct. R. 34(b)(4); *Funk v. Commissioner*, 123 T.C. 213, 217-18 (2004).

In any event, the Tax Court correctly upheld the failure-to-file, failure-to-pay, and failure-to-pay-estimated-tax penalties. (1-SER-29-

34.) I.R.C. § 6651(a)(1) imposes a penalty on a taxpayer who fails to timely file a return and I.R.C. § 6651(a)(2) imposes a penalty for failure to pay timely the amount of tax shown on a return, unless the taxpayer demonstrates that the failure was due to reasonable cause and not due to willful neglect. A substitute return made by the IRS under I.R.C. § 6020(b) is treated as the return filed by the taxpayer for purposes of determining whether the § 6651(a)(2) penalty applies. I.R.C. § 6651(g)(2); *Cabirac v. Commissioner*, 120 T.C. 163, 170 (2003).

As the Tax Court correctly found (1-SER-31), the Commissioner introduced evidence of such returns here reflecting tax liabilities that had not been paid. Taxpayers did not allege that their failure to pay was due to reasonable cause and not willful neglect. Taxpayers also failed to make estimated tax payments, although they were required under I.R.C. § 6654 to do so. Accordingly, the Tax Court's findings that taxpayers are liable for these penalties is not clearly erroneous.

CONCLUSION

The order and decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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MARCH 29, 2022

STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, counsel for the Commissioner respectfully inform the Court that they are aware of the following related case that is pending in this Court:

Mottahedeh v. Commissioner (9th Cir. No. 19-71410)

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