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Home Concrete & Supply Redux?

Expansive Interpretation of the "Fraud" Exception to the Three-Year Statute of Limitations

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As a general a rule, the Internal Revenue Service has three years from the date a tax return is filed to propose adjustments to that return or lose the right to do so.[1] However, the Internal Revenue Code also provides exceptions under which the three-year period can be extended. The exceptions most frequently relied on by the IRS are those that provide for either a six-year period (for omissions of gross income in excess of 25 percent of the amount of gross income stated in the particular tax return)[2] or for an unlimited assessment period (in the case of a fraudulent tax return).[3]

The justification for the extended assessment periods in the case of fraudulent conduct or an over 25 percent omission is that tax revenue is the lifeblood of government and that large or fraudulent omissions are thought to be harder for IRS to detect, investigate and propose to assess within the three-year period allowed by 26 U.S.C. §6501(a).

The determination as to whether there is a 25 percent or more omission of gross income or whether a tax return is false or fraudulent with the intent to evade tax is, at bottom, a factual determination in each case. However, until recently, the meaning of the statutory exceptions themselves were not in dispute.

IRS Seeks Broader Interpretation of the Fraud Exception

Faced with delays in detecting and/or addressing tax compliance issues associated with particular groups of taxpayers, the IRS has become creative in arguing that the exceptions are far broader than commonly understood.

With respect to IRC §6501(e), which provides for a six-year period in the case of a 25 percent or more omission of gross income, IRS aggressively argued (with some degree of success) that an omission resulting from the use of an inflated basis in computing the gain on a sale or other disposition of an asset that was reported as part of "gross income" was the same as omitting the transaction from the tax return entirely or understating the sales price. The IRS even promulgated a regulation adopting its interpretation of Section §6501(e).

Only after the U.S. Supreme Court decided *United States v. Home Concrete & Supply*, LLC[4] in 2012 and rejected the IRS' position was that issue finally put to rest. However, the IRS has been arguing for a similarly expansive interpretation of the "fraud" exception to the statute of limitations. That argument has yet to reach the Supreme Court but has generated differing results in the courts below. In many ways, the IRS' position with respect to the "fraud" exception has parallels in the *Home Concrete* case and the positions IRS took there.

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Making the Case to Extend Culpability to Preparers

Home Concrete arose in the context of the IRS' attack on tax shelter transactions marketed by some major accounting and law firms in the late 1990s to early 2000s. These transactions were popular tools for high-income taxpayers to avoid paying tax on large amounts of capital gain or ordinary income realized from (typically) the sale of a business or exercise of employee stock options. While there were many variations, in general, a taxpayer would enter into a purported investment transaction that was pre-planned to generate a large paper loss, which offset

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the large gain or income event that had or was about to occur. Typically, the key to the loss transaction was the claim that the taxpayer's basis in the asset disposed of was much higher than his/her actual cash outlay. This was accomplished through clever use of various Internal Revenue Code provisions to arrive at the desired result. The tax losses were significant, and the IRS had great difficulty in identifying which taxpayers were using these devices because, oftentimes, the accounting firms, or others who promoted them, attempted to minimize the transaction's "footprint" on the taxpayer's return in various ways. Often, only after enforcement of John Doe summonses served on the accounting firms or others involved in promoting a particular transaction was the IRS able to identify all the taxpayers who used it. By then, in some cases, the normal three-year statute had expired. *Home Concrete* was such a case. This led IRS to creatively argue for a broader interpretation of the six-year statute of limitations provision in IRC 6501(c) to avoid the bar of the statute of limitations.

High-income taxpayers using tax shelter transactions are only part of the problem IRS faces in identifying and addressing non-compliant conduct. A huge amount of tax revenue is lost each year as a result of unscrupulous tax preparers who attract clients by offering to obtain large refunds. Often, these refunds are accomplished by greatly inflating the taxpayer's allowable deductions. The IRS has devoted significant criminal and civil enforcement resources to either prosecuting or enjoining such preparers (or both) but, in the process, has often not made the required adjustments to the returns of the clients in a timely manner because the case against the preparer took precedence.

Faced with both the prospect of large sums of lost tax revenue and the negative publicity that allowing culpable taxpayers to escape paying their just due would create, the IRS looked to §6501(c)(1), which provides for an unlimited period to assess additional tax against a taxpayer in the case of a false or fraudulently filed return.

Until 2007, no court had sanctioned an IRS attempt to apply the fraud exception except where the culpable (fraudulent) conduct was that of the taxpayer, rather than that of his/her tax preparer or some other person who provided information to the tax preparer. Indeed, as late as 2003, the U.S. Tax Court had held that it was only fraudulent conduct by the taxpayer that gave rise to the unlimited assessment period. [5]

However, in 2007, in a little-noticed but officially reported Tax Court opinion issued in *Allen v. Commissioner*, the Tax Court upheld IRS use of the unlimited assessment period for fraud to assess additional tax (but not the related 75 percent civil fraud penalty) against a customer of a fraudulent return preparer based on the conduct and intent of the preparer, rather than that of the taxpayer himself.[6]

The Tax Court reached this result by interpreting the legislative intent behind the predecessor of IRC §6501(c)(1) and concluding that the exception was triggered by the filing of a false or fraudulent return with the intent to evade tax regardless of whether that intent was held by the taxpayer who filed the return or was held by his/her preparer (possibly for motivations totally independent of those of the taxpayer).

In *Allen*, the taxpayers were clients of a tax preparer who evidently made a practice of artificially inflating the deductions reported on his clients' tax returns resulting in larger refunds to the clients and (presumably) larger fees and more customers for the preparer.

In its zeal to prosecute Allen's preparer, the IRS failed to make a corrected assessment against Allen for the years in question within the three-year period and, to avoid being barred from doing so, the IRS for the first time argued that the preparer's conduct in preparing a fraudulent return for Allen was, in and of itself, sufficient for the "fraud" exception in IRC §6501(c) to apply and to keep the statute of limitations open for assessment of a tax deficiency without proving that Allen himself possessed any fraudulent intent.

Taken to its logical conclusion, if all that is required is that someone associated with the preparation and filing of the particular tax return possessed the requisite fraudulent intent, the actions of an unscrupulous and criminally minded preparer for his/her own benefit (i.e., to defraud the underlying taxpayer and obtain improper tax refunds without the taxpayer's knowledge) can suffice and serve as a basis for the IRS to seek recoupment of the lost tax revenue from the taxpayer himself despite the expiration of the normal three-year assessment period.

Indeed, the Second Circuit Court of Appeals has so held in *CityWide Transit, Inc. v. Commissioner*.[7] In the latter case, the "preparer" was engaged to represent the taxpayer in connection with obtaining a payment plan to satisfy preexisting tax obligations. The "preparer" scammed the taxpayer into providing him with a substantial amount of money ostensibly to make the necessary payment arrangements and to file and pay the taxes currently due. Unbeknown to the taxpayer, the "preparer" converted the funds to his own use and prepared and filed tax returns for the taxpayer claiming an improper credit to drastically reduce the taxes due and used a small portion of the embezzled funds to satisfy the taxes due on the false returns. The preparer was prosecuted but died before sentencing. Several years after the three-year statute of limitations passed, IRS sought to collect the correct amounts from the taxpayer who (understandably) objected.

Although Judge Vazquez of the Tax Court ruled that the facts distinguished the case from *Allen* and found the fraud exception inapplicable to hold the assessment period open against *CityWide Transit*,[8] the IRS appealed and prevailed on appeal to the Second Circuit.

The appellate court held that if it was the preparer's intent to file a fraudulent tax return, it did not matter whether or not the fraudulent return was filed with the taxpayer's knowledge or whether the taxpayer in any way benefitted from the filing.

Some have suggested that the potentially broad implications of the holdings in *Allen* and *CityWide Transit* are the result of improvidently made stipulations by the taxpayers' counsel in those cases and that absent such helpful stipulations, IRS would not have so easily succeeded in asserting the fraud exception. Several subsequent cases tried in the Tax Court have seemed to bear this out, but nothing in those opinions suggests that the Tax Court has reconsidered its *Allen* opinion.[9]

Thus, in cases tried before the United States Tax Court, fraudulent conduct by either the taxpayer or the preparer in the preparation of a false tax return will keep the statute of limitations for assessment open for that tax period indefinitely because, in the Tax Court's view, "the statute keys the extension to the fraudulent nature of the return, not to the identity of the perpetrator of the fraud."

Allen Drives Expansion of the Universe of Bad Actors

The implications of the *Allen* holdings go beyond situations involving rogue tax preparers, and the government has used *Allen* in at least one reported case to attempt to keep the statute of limitations open in a tax shelter case similar to *Home Concrete* pending in the Court of Federal Claims. *BASR Partnership v. United States*.[10]

Similar to *Home Concrete*, BASR involved a purported investment partnership formed to implement the Jenkins & Gilcrist ("J&G") "short sale" tax shelter transaction in which an investment loss is created by use of an artificially created tax basis in an asset that was then sold to generate a paper loss. The transaction occurred in 1999 and was reported on a tax return filed in October 2000. IRS did not identify BASR as a participant in the J&G tax shelter promotion and did not actually formally disallow the loss until January 2010. By then, both the three- and six-year statutes of limitation had expired. The IRS argued that IRC §6501(c)(1) allowed it to make the assessment because the architect of the scheme, J&G partner Irwin Mayer, had pleaded guilty to tax fraud for his role in creating the scheme.

IRS conceded that neither the owners of the BASR partnership nor the preparer of the tax return were involved in creating the scheme and did not knowingly participate in a fraudulent scheme (as opposed to engaging in legitimate but aggressive tax planning). However, IRS claimed that Mayer "orchestrated" the preparation of the BASR return and that Mayer's fraudulent intent was sufficient to hold the statute open. In this regard, the position advanced in BASR goes beyond *Allen* because it expands the universe of actors whose intent might be relied on to prove fraud to persons beyond the taxpayer who signed the return and the accountant who prepared it. In essence, the argument is the same as the one the Tax Court rejected in its pre-*Allen* 2003 holding in *Christians v. Commissioner*, where the IRS sought to rely on the fraudulent intent of the taxpayer's father in supplying information to the preparer of his son's tax return.

The Court of Federal Claims concluded "that the fraudulent intent referenced in IRC §6501(c) is by implication limited to the fraud of the taxpayer." It expressly rejected as erroneous the Tax Court's interpretation of the legislative history of the "fraud" exception in prior versions of the tax code as well as the Tax Court's conclusion that it was the fraudulent nature of the return that was filed rather than the identity of the fraudulent actor that triggered the exception.

The government appealed and the BASR case was argued before the United States Court of Appeals for the Federal Circuit in December 2014.

Given the numerous potential scenarios in which IRS might benefit from the expansive interpretation of IRC §6501(c) adopted by the Second Circuit and the Tax Court, it can be expected that it would ask the Supreme Court to review any contrary decision by the Federal Circuit. The stage is thus set for *Home Concrete*, Round 2.

[1] IRC §6501(a), 26 U.S.C. §6501(a)

[2] IRS §6501(e), 26 U.S.C. §6501(e)

[3] IRC §6501(c)(1), 26 U.S.C. §6501(c)(1)

[4] United States v. Home Concrete & Supply, LLC, 132 S Ct. 1836 (2012)

[5] Christians v. Commissioner, T.C. Memo 2003-130

[6] Allen v. Commissioner, 128 T.C. 37 (2007)

[7] CityWide Transit, Inc. v. Commissioner, 709 F.3d 102 (2d Cir. 2013)

[8] CityWide Transit, Inc. v. Commissioner, T.C. Memo 2011-297

[9] Ericksen v. Commissioner, T.C. Memo. 2012-194; Browning v. Commissioner, T.C. Memo, 2011-261; Ames-Mechelke v. Commissioner, T.C. Memo 2013-176

[10] BASR Partnership v. United States, 113 Fed. Cl. 181 (Cl. Ct. 2013)