Penalties

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Can an Innocent Taxpayer Be Subject to an Unlimited Statute of Limitations Because of the Return Preparer's Fraud?

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The normal statute of limitations is three years from the date the return is filed. That is how long the IRS has to challenge the accuracy of the return and assess a deficiency.[1] However, the three-year statute of limitations does not apply where the tax return is false or fraudulent. Specifically, Code Sec. 6501(c)(1) provides that "[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time." How does this rule apply in cases where a tax return preparer or tax advisor fraudulently causes an understatement even though the taxpayer is blissfully unaware of any problems on the return? Some courts have held that, if a tax return preparer willfully understates tax liability, the IRS can assess a tax at any time, even if the taxpayer is innocent and blissfully unaware of any problem on the return.

In *V. Allen*,[2] the Tax Court ruled that Code Sec. 6501(c)(3) applies even where the tax return preparer alone intended to evade taxes, and not the taxpayer. *Allen*'s reasoning is based on the assumption that there is no statute of limitations in the case of fraud on a tax return because of "the special disadvantage to the Commissioner in investigating fraudulent returns [which is also] present when the income tax return preparer committed the fraud that caused the taxes on the return to be understated."[3] In other words, the policy of eliminating the statute of limitations is not a penalty imposed on the taxpayer for perpetrating a fraud. Rather, the statute of limitations is eliminated in the case of fraud out of fairness to the IRS because fraud makes it all the more difficult for the IRS to discover problems on the return.

The Second Circuit took *Allen* one step further in *City Wide Transit, Inc.*[4] In *City Wide*, a tax return preparer (who falsely told his client that he was a CPA), prepared returns for his client's signature that showed the correct tax liability. After executing the returns, the client gave the preparer checks to submit to the IRS. Once the preparer received the executed tax returns and checks from his client, he prepared new, fraudulent tax returns that showed a significantly lower tax liability. The preparer then deposited his client's checks to the IRS into his own account (after modifying the name of the recipient), and then he issued checks to the IRS from his own account, equal to the amount of tax on the fraudulent return.

Upon discovering the preparer's fraud, the IRS sought to assess the correct tax liability against the taxpayer more than three years after the returns were filed. The Tax Court[5] held that Code Sec. 6501(c)(1) did not apply to these facts, because the preparer's motivation was not to evade his client's tax liability, but to perpetrate a fraud against his client. The Second Circuit reversed the Tax Court's decision and held that Code Sec. 6501(c)(1) "is agnostic as to the attendant motivations for submitting a fraudulent return and only requires that the Commissioner prove a fraudulent return was filed with the intent to evade … paying a tax otherwise due."[6] The court did, however indicate that Code Sec. 6501(c)(1) may not apply if a third party's fraudulent conduct that is extraneous to the tax return, causes the taxpayer to file a false return.[7] An example of this would be an accountant who embezzles a company by posting personal expenses to the client's corporate ledger as a business expense, which causes the client to prepare a false tax return.[8]

Fortunately, not all the decisions on this issue have gone against the innocent taxpayer. In *BASR Partnership*,[9] the United States Court of Federal Claims significantly departed from *Allen* and *City Wide* and held that Code Sec. 6501(c)(1) does not apply where the taxpayer had no knowledge of the fraud. The taxpayers in *BASR* consulted with a tax lawyer prior to selling their business at a significant profit. The tax lawyer advised his clients to form a new partnership (BASR) to which they would contribute the stock of the company to be sold, and BASR would obtain an artificially increased basis in the stock of the company as a result of a Code Sec. 754 election.[10] The tax lawyer's intention was to eliminate gain upon the sale of the business. BASR and its partners filed tax returns for the year at issue in October 2000. All the tax returns were prepared by the same accountant (they were not prepared by the tax lawyer who promoted the structure).

The IRS did not audit the returns until August 2006, and it issued a Final Partner Administrative Judgment in January 2010. The taxpayers filed a motion for summary judgment with the Court of Federal Claims on the ground that the IRS's assessment was beyond the three-year statute of limitations. The IRS conceded that it could not prove that the taxpayers intended to file false or fraudulent returns, but they nevertheless asserted that three-year statute of limitations did not apply because the accountant (who, in the IRS's words was the "puppet master" of the tax lawyer) knowingly prepared fraudulent tax returns. Accordingly, under *Allen* and *City Wide*, argued the IRS, the statute of limitations would remain open indefinitely.

Despite the IRS's policy arguments as to why there should be no statute of limitations where a preparer prepares a false or fraudulent tax return, the court held that Code Sec. 6501(c)(2) by its terms only applies where the fraud is attributable to the taxpayer. Specifically, the court noted that Code Sec. 6501(a) provides that "for purposes of this chapter, the term 'return' means the return required to be filed by the taxpayer." According to the court, if Code Sec. 6501(a) is expressly limited to a return filed by the taxpayer, then it follows that the fraudulent intent of Code Sec. 6501(c)(1) is also limited to the fraud of the taxpayer, and not to a third party. The Court acknowledged that it is departing from *Allen* and *City Wide*, but it noted that unless the Federal Circuit reverses its decision, it must interpret the statute as written.

While fraud on a return does make it more difficult for the IRS to discover a deficiency, any resulting tax must be paid by the taxpayer, not the preparer or some other party who may have perpetrated the fraud. It seems inappropriate to subject an innocent taxpayer to a different statute of limitations than other taxpayers simply because they were defrauded by their return preparer. Nevertheless, it is likely that the IRS will appeal the decision in the *BASR* case, particularly given its prior success in litigating this issue.

ENDNOTES

1 *See* Code Sec. 6501(a).
2 *V. Allen*, 128 TC 37, Dec. 56,851 (2007).
3 *Id.*, at 40.
4 *City Wide Transit, Inc.*, CA-2, 2013-1 USTC ¶50,211, 709 F3d 102.
5 *City Wide Transit, Inc.*, 102 TCM 542, Dec. 58,821(M), TC Memo. 2011-279.
6 *See City Wide Transit, Inc., supra* note 4.
7 *Id.*, at 108.
8 *Id.*
9 *BASR Partnership*, FedCl, 2013-2 USTC ¶50,527, 113 FedCl 181.
10 This is a somewhat oversimplified summary of the actual structure, the intricate details of which are not relevant to the case or this article.