

What You Don't Know Can Hurt You: Paying for Preparer Fraud

By Adam S. Wallwork

Adam S. Wallwork is an attorney with Osler, Hoskin & Harcourt LLP in New York. He practices tax law with an emphasis on tax litigation.

In this article, Wallwork examines the circuit split that has recently developed over whether a return preparer's fraud is sufficient to toll the three-year statute of limitations on federal tax assessments. By rejecting the Tax Court's rule, the Court of Federal Claims and the Federal Circuit have created a situation in which wealthy, well-advised taxpayers may be able to completely escape the perpetual liability and compound interest that their less-fortunate counterparts must face.

For as long as there has been a federal income tax, there have been time limits on its collection. Supreme Court Justice Robert H. Jackson explained in *Rothensies v. Electric Storage Battery Co.*¹ that statutes of limitations in federal tax matters "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared."

But that rationale holds only if the taxpayer is not personally guilty of defrauding the government. If the IRS had the same three years to assess fraudulent filers as it does honest ones, tax evaders would have an incentive to conceal income and assets from the IRS in the hope that their fraud would go undetected until after the time for assessment had passed. To deter taxpayers from evading taxes, and to punish those who do, since 1919 Congress has authorized the IRS to collect taxes, interest, and penalties from tax evaders "at any time."

The Internal Revenue Code generally gives the IRS three years from the taxpayer's filing date to assess any unpaid taxes. However, the IRS has an unlimited amount of time to assess taxpayers who file a "fraudulent return with the intent to evade tax." The Supreme Court held in *Badaracco v. Com-*

*missioner*² that the fraudulent-return exception of section 6501(c)(1) forever suspends a "Sword of Damocles over a taxpayer who at one time may have filed a fraudulent return." This means that taxpayers who file fraudulent returns cannot later correct their fraud by filing truthful ones. Until recently, this harsh rule had been reserved for intentional tax evaders, but in 2007 the Tax Court changed the rules.

A. Deficiency Litigation

However fair the rule of perpetual assessment for tax evaders may have once been, it is no longer the rule of law in courts that hear more than 95 percent of taxpayers' claims against the IRS. The Tax Court and, more recently, the Second Circuit have held that even victims of tax fraud must forever await the tax collector.

1. The Tax Court. In *Allen v. Commissioner*,³ the Tax Court for the first time upheld the IRS's assessment of a taxpayer who'd done nothing wrong. The taxpayer in *Allen* was a middle-class truck driver for United Parcel Service Inc. Like the majority of Americans, Vincent Allen hired a tax professional to prepare his 1999 and 2000 tax returns but, unlike most, his tax preparer turned out to be a fraud. In 2001 the IRS Criminal Investigation division began to investigate Allen's CPA for criminal tax fraud and interviewed Allen and his wife, separately, in November 2003. At the time, Allen identified numerous business expense deductions that he believed his tax return preparer might have falsified.

There is no question that the IRS could have assessed the taxpayer for his accountant's erroneous deductions for the 2000 tax year in November 2003 or at any time before April 15, 2004. But the IRS neglected to do so and later claimed that Allen was perpetually liable for understatements because of the fraud by his CPA.

Allen stipulated that his accountant had prepared the 1999 and 2000 returns fraudulently, while the IRS agreed that Allen had not intended to commit tax fraud. Nevertheless, the Tax Court, as if reading section 6501(c)(1) for the first time, found that "nothing in the plain meaning of the statute suggests the limitations period is extended only in

¹329 U.S. 296 (1946).

²464 U.S. 386 (1984).

³128 T.C. 37 (2007).

the case of the taxpayer's fraud. The statute keys the extension to the fraudulent nature of the return, not to the identity of the perpetrator of the fraud." Therefore, the court concluded that Allen was perpetually liable for taxes and interest on amounts due in 1999 and 2000, which he would have paid on time but for his accountant's fraud.

2. The Second Circuit. Four years later, the *Allen* doctrine of preparer fraud was extended even further by the Second Circuit in *City Wide Transit Inc. v. Commissioner*.⁴ In that case, a New York City bus company for disabled schoolchildren challenged an otherwise untimely assessment premised on the fraud of the company's accountant, Manzoor Beg, who defalcated tax payments using forged returns.

Ray Fouche owned several bus companies in New York, including City Wide Transit Inc., and hired a payroll company to prepare the companies' quarterly employment tax returns. By the end of 1998, however, Fouche's companies collectively owed the IRS approximately \$700,000, and Fouche hired Beg in April 1999 to negotiate a reduction in her companies' payroll tax liabilities.

Sometime after June 2000, Beg lied to Fouche and convinced her that he had worked out a comprehensive tax settlement with the IRS that required him to personally deliver City Wide's quarterly tax returns and payments to the revenue agent with whom he'd been negotiating. Fouche delivered the requested tax returns and checks to Beg, who embezzled the funds and covered his tracks by filing fraudulent tax returns understating the amount of taxes City Wide owed.

The United States eventually discovered Beg's embezzlement scheme and obtained a conviction against him for filing false returns on City Wide's behalf but not before the accountant had stolen more than \$280,000 from the company. Beg died soon after his conviction, and the IRS later came after the victim company for unpaid taxes and interest, more than eight years after Beg's theft of the tax payments.

City Wide challenged the assessment in the Tax Court as untimely. Although the Tax Court refused to allow the IRS's assessment of City Wide on the ground that Beg's tax fraud had been secondary to his fraud on the company, the Second Circuit reversed. The Second Circuit adopted the preparer fraud doctrine in *Allen* but found that the Tax Court misapplied it in this case. It held that the Tax Court had confused Beg's underlying motive for filing fraudulent tax returns (that is, embezzlement) with the question whether he had intentionally understated City Wide's tax liabilities on IRS returns.

⁴709 F.3d 102 (2d Cir. 2013).

Because the taxpayer acknowledged that its accountant had intentionally filed false returns on its behalf, the Second Circuit panel found clear and convincing evidence of the preparer's tax fraud, which was all that was required to toll the statute of limitations indefinitely under *Allen*.

Since the Tax Court applies the rule of law in the circuit for which appeal would lie, taxpayers in New York, Connecticut, and Vermont can expect to pay taxes and interest on the basis of outrageous criminal conduct committed by their accountants, not just against the IRS but against the taxpayers themselves.

B. Refund Litigation

This extraordinary doctrine appeared to have no limit until the Court of Federal Claims rejected it in a decision later upheld by the Federal Circuit. *BASR Partnership v. United States*⁵ arose out of a complex transaction planned by the government's star witness in the first tax scandal in modern history to bring down a national law firm. Three tax partners in the now-defunct law firm of Jenkens & Gilchrist engaged in a multibillion-dollar tax fraud scheme between 1994 and 2004. One of the tax partners, Erwin Mayer, turned state's witness and identified the taxpayer's partnership tax structure as a fraudulent one he'd developed, even though he'd convinced the taxpayer and his accountant that the transaction was legitimate at the time it was reported to the IRS. For his help, Mayer received only six months in prison, while his partners in crime received sentences of eight and 15 years. Both the Court of Claims and the Federal Circuit rejected the Tax Court's doctrine of preparer fraud because it threatened to make the issue of fraud dependent on third parties with very different motives than the taxpayer, which is both forbidden by the tax code and grossly unfair.

Given the state of the law, the taxpayer's choice of where to litigate a case of preparer fraud may be outcome determinative, and the split of authority between the Tax Court and the Claims Court has created a situation in which taxpayers must pay to play. Federal courts generally try to prevent litigants from forum shopping, but the rules of tax litigation are different. Taxpayers cannot get into the Claims Court unless they can pay their deficiency upfront, and those who cannot afford to pay are relegated to the Tax Court. Thus, the Tax Court's rule of preparer fraud falls most heavily on those least able to bear it. Those who cannot afford to pay their tax deficiency are held perpetually liable for taxes and compound interest that their wealthier

⁵113 Fed. Cl. 181 (2013), *aff'd*, 795 F.3d 1338 (Fed. Cir. 2015).

and better-advised counterparts could escape by litigating in the Claims Court.

The Supreme Court must eventually step in to correct this injustice. But until it does, taxpayers who can afford to pay upfront a deficiency caused by preparer fraud should generally do so if the statute of limitations is an issue in the case.

Let the news find you.

Customized e-mail alerts. Let the tax news and analysis you need find you fast with our customized e-mail alerts. Simply profile your needs, by code section, jurisdiction, document type, subject, search terms, and more, and we'll get you what you want, when you want it. It's one part of a great personalized service.

Visit taxanalysts.com today.

taxanalysts[®]

Tax Notes Today[®] ▲ State Tax Today[®] ▲ Worldwide Tax Daily[®]