Office of Chief Counsel
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Memorandum

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subject: Assessment of Tax against S-Corporation shareholder based on a fraudulent Form 1120S return

This Chief Counsel Advice responds to your request for assistance dated March 27, 2012. This advice may not be used or cited as precedent.

LEGEND

A =
B =
Corporation:

ISSUE

Whether a fraudulent Form 1120S S-Corporation return extends the period of limitation on assessment under I.R.C. § 6501(c)(1) for the personal tax liability of a shareholder who did not take part in the fraud?

CONCLUSIONS

The period of limitations on assessment is not extended under I.R.C. § 6501(c)(1) for the personal tax liability of an S-Corporation shareholder who did not take part in the fraud reflected on the S-Corporation's Form 1120S tax return.

FACTS

All of the following facts apply to tax year 2001. The taxpayer, A and , B, were each 50% owners of Corporation, an S-Corporation engaged in the business of roofing, remodeling, and repairing residential and commercial buildings. Corporation often hired subcontractors to do work for Corporation’s customers, with the subcontractors billing Corporation for work they performed. The subcontractor’s invoices would include the address of the relevant Corporation job site.

B contacted vendors who did work for him personally, and instructed them to falsify addresses on their invoices. It would then appear that these vendors did work for Corporation’s customers, rather than for B. In addition, B changed the addresses on other personal invoices from his own address to the addresses of Corporation job sites. In this way, B caused numerous personal expenses to be falsely recorded on Corporation’s corporate books and records and deducted on Corporation’s 2001 Form 1120S corporate tax return as business expenses. Because the Form 1120S return overstated Corporation’s deductions, it also understated the amount of income that passed through to Corporation’s two shareholders, A and B. Thus both A and B omitted income from their personal tax returns for 2001.

B was ultimately convicted of one count of 18 U.S.C. § 371, Conspiracy to Commit Mail Fraud and Tax Fraud, one count of 26 U.S.C. § 7201, Tax Evasion, one count of 26 U.S.C. § 7206(1), Filing a False Individual Tax Return, and one count of 26 U.S.C. § 7206(1), Filing a False Corporate Tax Return for the year 2001. A did not sign Corporation’s Form 1120S; and there is no evidence that he participated in the preparation of the return. Neither is there any evidence that A participated in, or was aware of, B’s fraudulent activities with respect to Corporation. The Service would like to assess the deficiency associated with A’s personal return, but it has been over 10 years since A filed his Form 1040 for tax year 2001.

LAW AND ANALYSIS

I.R.C. § 6501(a) generally requires the Service to assess any tax within three years after the return was filed. The term “return” means the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction or credit). I.R.C. § 6501(a). There are several exceptions to the three-year period for assessment. I.R.C. § 6501(c)(1) provides for an unlimited assessment period “in the case of a false or fraudulent return with the intent to evade tax.”[1] The theory behind this exception is that “[a]n extended limitations period is warranted in the case of a false or fraudulent return because of the special disadvantage to the Commissioner in investigating these types of returns.” Allen

[1] I.R.C. § 6501(e) provides for a 6 year limitations period in cases in which the taxpayer has omitted from gross income an amount in excess of 25 percent of the amount of gross income shown on the return. In this case, it has been more than 6 years since A filed his Form 1040 for tax year 2001. Therefore, the assessment statute of limitations is not open under I.R.C. § 6501(e).

v. Commissioner, 128 T.C. 37, 40 (2007) (citing Badaracco v. Commissioner, 464 U.S. 386, 398 (1984)). The Tax Court has stated that the definition of fraud for purposes of § 6501(c)(1) is the same as that for the I.R.C. § 6663 fraud penalty. Neely v. Commissioner, 116 T.C. 79, 85 (2001).

The Service has suggested that the limitations period may be held open indefinitely for As return, based on the fraudulent Form 1120S filed by B. For the reasons that follow, we conclude that I.R.C. § 6501(c)(1) does not apply to A's return. The question whether a return is false or fraudulent with the intent to evade tax has generally focused on the intent of the taxpayer who filed the return. There are certain exceptions to this general focus, namely for cases involving (1) joint returns of husband and wife; (2) TEFRA partnerships; or (3) fraud committed by a third party such as a return prepaper. As discussed more fully below, none of these exceptions can be extended to apply a longer period of limitations to make an assessment based on A's individual tax return.

The limitations period for assessing the income tax liability of an S-Corporation's shareholder runs from the date the shareholder filed his or her return, not from the date the 1120S was filed. I.R.C. § 6501(a); Bufferd v. Commissioner, 506 U.S. 523 (1993). Further, "the law provides that a shareholder in a Subchapter S corporation, like a partner in a partnership, is not automatically guilty of fraud by reporting his share of fraudulently understated taxable income." Riley v. Commissioner, T.C. Memo. 1981-705 (citing Estate of Roe v. Commissioner, 36 T.C. 939 (1961)). Thus the Tax Court has consistently examined the activities of each individual shareholder when considering cases involving S-Corporations. These cases more often deal with the question whether the individual shareholder may be held liable for the fraud penalty. See Briggs v. Commissioner, T.C. Memo. 2000-380; Prewitt v. Commissioner, T.C. Memo. 1995-487; Riley, T.C. Memo. 1981-705. However, the same principle has been applied to the question whether the statute of limitations on assessment is held open for a particular shareholder. See Snyder v. Commissioner, T.C. Memo. 1985-5 (concluding that shareholder's return was fraudulent with the intent to evade tax and therefore the statute of limitations provided in section 6501(a) did not prohibit the assessments).

The statutory requirement of an intent to evade tax does not necessarily mean that each taxpayer who files a return must have committed fraud. For example, it is well-settled that fraud by one spouse in filing a joint return holds the assessment statute of limitations open as to the other spouse as well. See Estate of Upshaw v. Commissioner, 416 F.2d 737 (7th Cir. 1969); Vannaman v. Commissioner, 54 T.C. 1011, 1018 (1970). ("[E]ven if the joint-filing husband is the only one who committed fraud in filing the return and making any underpayment . . . the bar of the statute of limitations is still removed from the deficiencies determined against the wife."). This conclusion is based in large part on the joint nature of the return and resulting tax liability by virtue of I.R.C. § 6013(d)(3). See also Snyder, T.C. Memo. 1985-5 at n.18 ("[T]he fraud on the part of [the husband] is sufficient to invoke sec. 6501(c), and once the bar of the statute of limitations is removed, [the wife] remains liable for the deficiencies by virtue of the joint and several liability provisions of sec. 6013(d)(3).").

On the other hand, the Tax Court has analyzed the fraudulent intent of each spouse individually when they file separate returns, even when the adjustments are based on income from the same S-Corporations. Jackson v. Commissioner, T.C. Memo. 1964-330. In Jackson, a husband and wife were both part owners of two C-Corporations, Jackson Manufacturing Company and Cleveland Chair Company. Mr. and Mrs. Jackson each reported their income from the companies on separate tax returns. The Tax Court found that certain returns of the two C-Corporations, as well as certain of Mr. Jackson's individual returns, were false and fraudulent with the intent to evade tax. With respect to Mrs. Jackson, however, the Court stated that because husband and wife filed separate returns, "proof that [the] husband's returns were false or fraudulent . . . is not clear and convincing evidence that [the wife]'s returns were likewise false or fraudulent." Id. (citing United Dressed Beef Co., 23 T.C. 979 (1955). While the Service had raised a suspicion of fraud by demonstrating that Mrs. Jackson worked for the two companies, this was not sufficient to sustain a finding of fraud on her part in the absence of affirmative evidence against her, and the assessments were barred.

In the case at hand, A and B as co-owners of Corporation are not jointly and severally liable for the tax. Each shareholder in an S-Corporation is taxed separately on his individual income tax return, and A and B did in fact file their own personal returns. Their situation is more analogous to the husband and wife filing separately in Jackson, than to the situation in which a husband and wife file a joint return. As in Jackson, in this case there was fraud with respect to Corporation's corporate return. As with Mrs. Jackson, these fraudulent amounts were reflected on A's return. However, because like Mrs. Jackson A was not responsible for the fraud, the § 6501 period of limitations should not be held open for A's return.

There are some situations in which the Service may rely on fraud committed by a third party to hold open the statute of limitations for another's return. For example, TEFRA partnership rules provide extensions of the period of limitations for any tax attributable to a partnership item with respect to which a partner has, with the intent to evade tax, signed or participated (directly or indirectly) in the preparation of a partnership return that includes false or fraudulent items. I.R.C. § 6229(c)(1)(A). See Transpac Drilling Venture 1983-2 v. United States, 83 F.3d 1410, 1414-15 (Fed. Cir. 1996). This extension is unlimited for partners who have signed or participated in the preparation of the false or fraudulent partnership return. Id. For partners who do not sign or participate in the preparation of the return, but report items pursuant to such a return, the period of limitations is extended from three years to six years. I.R.C. § 6229(c)(1)(B); Transpac Drilling Venture 1983-2, 83 F.3d at 1414-15.

While this case may be analogous to the TEFRA partnership situation in that fraudulent items on a corporate return were also reflected on the individual return of a non-fraudulent shareholder, § 6229(c)(1)(B) does not allow for an assessment to be made against A. First, S-Corporations are not subject to the TEFRA partnership audit procedures for tax years beginning after December 31, 1996. Small Business Job

Protection Act of 1996, Pub. L. No. 104-188, § 1307(c)(1), 110 Stat. 1755, 1781. Further, § 6629(c)(1)(A) extends the period of limitations for only six years for partners that did not sign or participate in the preparation of the partnership return. Even if this provision could be extended to S-Corporations in 1997 or later (and we do not think that it can), more than six years have passed since A filed his individual return.

Finally, in the recent case of Allen v. Commissioner, 128 T.C. 37 (2007), the Tax Court held that a return preparer's fraud can result in an unlimited period of limitations on assessment under I.R.C. § 6501(c)(1). In Allen, the Tax Court agreed with the Service's position that the fraud in question does not have to be committed by the taxpayer who filed the return. This was because "the special disadvantage to the Commissioner in investigating fraudulent returns is present if the income tax return preparer committed the fraud that caused the taxes on the returns to be understated." Allen, 128 T.C. at 40. In addition, allowing the fraud of a third person to hold the limitations period open is consistent with the general principal that statutes of limitation should be strictly construed in favor of the government. Id. at (citing Bufferd v. Commissioner, 503 U.S. at 526-27 n.6). When examining the fraud of a third party, the Tax Court has recently focused on whether that third party intended to evade tax, or whether such evasion was merely "an incidental consequence or secondary effect" of the third party's conduct. See Citywide Transit v. Commissioner, T.C. Memo. 2011-279 (appeal docketed).

In this case, B's fraud with respect to the corporate return may have "caused" tax to be understated on A's return. It is questionable, however, whether there is evidence of intent to evade tax directly associated with A's return. There is no evidence that B prepared A's individual tax return for 2001. Neither is there evidence that B intended to evade A's tax when he fraudulently filed Corporation's corporate return. It may be that he intended to evade only his own tax, and A's deficiency was merely a by-product of that intent. [redacted]

Ultimately, it is doubtful that Allen can be extended to allow for an unlimited assessment statute of limitations in this case. Such an extension would require the Tax Court to focus on the fraud of a third party who did not prepare or file the return at issue, which seems an unlikely legal and factual stretch.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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