DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: JOHN C. McDOUGAL
Special Litigation Assistant, Richmond District Counsel
CC:SER:VWV:RCH

FROM: Assistant Chief Counsel (Administrative Provisions & Judicial Practice) CC:PA:APJP

SUBJECT: Application of the Fraud Exception to the 3 Year Statute of Limitations

This Field Service Advice responds to your memorandum dated June 22, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

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LEGEND

Taxpayer =

Firm =

Employee =

ISSUE

Whether the fraud of a return preparer can be used as the basis for holding the statute of limitations open pursuant to section 6501(c)(1) of the Internal Revenue Code?

CONCLUSION

Pursuant to section 6501(a), the Service has 3 years from the time Taxpayer's return was filed to assess the deficiencies resulting from the disallowance of the diesel fuel excise tax credit. Section 6501(c)(1) provides an exception to the general 3 year statute of limitations period for a fraudulent return with the intent to evade tax. While section 6501(c)(1) does not expressly require that the "intent to evade tax" be the personal intent of Taxpayer, we conclude that only Taxpayer's intent is relevant. Thus, the fraudulent intent of the return preparer will not, by itself, provide a sufficient basis for applying section 6501(c)(1).

FACTS

Taxpayer is a truck driver. In , Taxpayer heard from another truck driver that an employee of Firm (hereinafter referred to as Employee) was able to obtain huge tax refunds for truck drivers based on their diesel fuel purchases. Taxpayer sought out the services of Employee for tax years

Employee is an experienced tax preparer and knew that Taxpayer was not entitled to the diesel fuel excise tax credit upon which each of the refunds was based. Employee was subsequently prosecuted for preparing false returns with respect to Taxpayer and several other truck drivers.

The Service proposes to issue a notice of deficiency to Taxpayer for tax years , disallowing the diesel fuel excise tax credit. The fraud penalty of section 6663 will not be asserted against Taxpayer. However, the Service proposes to assert the fraud of Employee as a defense in the event Taxpayer raises the statute of limitations as a bar to the assessment.

LAW AND ANALYSIS

Section 6501 of the Internal Revenue Code provides that, except as otherwise provided, tax must be assessed within 3 years after the return was filed, whether or not such return was filed on or after the date prescribed. As an exception to the general rule, section 6501(c)(1) provides that in 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.

The Supreme Court has noted that "Statutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government." Badaracco v. Commissioner, 464 U.S. 386, 391 (1984) (quoting E.I. du Pont de Nemours & Co. v. Davis, 264 U.S. 456, 462 (1924)). Statutes of limitation on assessment of tax are no exception. Lucia v. United States, 474 F.2d 565, 570 (5th Cir. 1973).

In order to determine whether section 6501(c)(1) applies to the facts described above, an understanding of the concept of "fraud" is necessary. Neither the Code nor the Treasury regulations provide a definition of "fraud." However, the Court of Appeals for the Fifth Circuit has provided the following guidance:

> Fraud implies bad faith, intentional wrongdoing and a sinister motive. It is never imputed or presumed and the court should not sustain findings of fraud upon circumstances which at most create only suspicion. . . . [The government's determination of a deficiency is presumptively correct, but when the government relies on an exception to the three-year statute of limitations] it bears the burden of proving its entitlement to rely on that exception. . . . There must be additional evidence, independent of the general presumption of correctness [of the deficiency determination], from which fraudulent intent on the part of the taxpayer can be properly inferred.

Payne v. Commissioner, 2000 U.S. App. LEXIS 20691, at *13-15, 2000-2 U.S.T.C. ¶ 50,668 (5th Cir. 2000) (citations omitted and emphasis added).

Further, the Court of Appeals for the Ninth Circuit has set forth the following "badges of fraud" that have consistently been followed by many other courts in determining the existence of fraud:

1. understatement of income;
2. inadequate records;
3. failure to file tax returns;
4. implausible or inconsistent explanations of behavior;
5. concealing assets;
6. failure to cooperate with tax authorities.

Bradford v. Commissioner, 796 F.2d 303, 307 (9th Cir. 1986). The courts that have applied the "badges of fraud" have done so with the taxpayer's activities and intent in mind. *See, e.g.*, Bacon v. Commissioner, T.C. Memo. 2000-257; Kaissy v. Commissioner, T.C. Memo. 1995-474. Further, as noted above, Payne v. Commissioner refers to the necessity of proving fraudulent intent "on the part of the taxpayer" and the Tax Court has indicated that "fraud by its very nature is a question of a taxpayer's intent." Kaissy v. Commissioner, T.C. Memo. 1995-474. In order to prove fraud, the Service may use circumstantial evidence, and as a result, a taxpayer's entire course of conduct can be considered in determining whether fraudulent intent exists. *See* Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); *see also* Stone v. Commissioner, 56 T.C. 213, 223-24 (1971), *acq. in result*, 1972-2 C.B. 3.

Section 6501(c)(1) is not the only section of the Code that pertains to fraudulent returns. Thus, in the absence of any definition of "fraud" for purposes of section 6501(c)(1), other sections of the Code can be looked to for guidance on the question presented. Section 6663 imposes a fraud penalty on a taxpayer when an underpayment of tax required to be shown on a return is due to fraud. Again, the term "fraud" is not statutorily defined and no regulations have been promulgated under section 6663. In the context of the fraud penalty, the longstanding definition of "fraud" was articulated in Mitchell v. Commissioner, 118 F.2d 308 (5th Cir. 1941). "Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing." Id. at 310. While this definition of "fraud" was set forth in the context of the fraud penalty, there is ample support to indicate the same definition should apply for purposes of section 6501(c)(1).

Thus, for example, the Tax Court has stated that "[t]he definition of 'fraud' for purposes of section 6501(c) is identical to the definition of 'fraud' under section 6653(b)."[1] Murphy v. Commissioner, T.C. Memo. 1995-76 (citing Asphalt Industries, Inc. v. Commissioner, 384 F.2d 229, 232 (3d Cir. 1967), *rev'g* 46 T.C. 622 (1966)). Applying the same definition of fraud for statute of limitations and fraud penalty purposes is logical in view of the history of these provisions. Many years ago, a single section of the Revenue Act contained the provisions establishing the fraud penalty and the statute of limitations for a fraudulent return. *See* Revenue Act of 1918, section 250(b), (d); *see also* Revenue Act of 1921, section 250(b), (d). By including both provisions in the same section of the

[1]The fraud penalty provisions of section 6653(b) were renumbered by the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106, and are now found in section 6663.

Revenue Act, Congress presumably intended that the term “fraud” would have the same meaning for both purposes. *See* Commissioner v. Estate of Ridgway, 291 F.2d 257, 259 (3d Cir. 1961), *nonacq.*, 1960-2 C.B. 8. We are not aware of any legislative history or court cases indicating that fraud may be defined differently for purposes of sections 6501(c)(1) and 6663.

Therefore, in resolving the issue presented, it is helpful to consider whether an income tax return preparer’s fraudulent intent would provide a sufficient basis for imposing a fraud penalty on a taxpayer under section 6663. As explained below, we believe that the imposition of a fraud penalty requires proof of fraudulent intent on the part of a taxpayer; proof of a return preparer’s fraudulent intent is insufficient. This supports our conclusion that proof of a return preparer’s fraudulent intent is insufficient to make section 6501(c)(1) applicable under the facts presented.

One of the policies underlying section 6663 (formerly section 6653(b)) is to protect the revenue and compensate the government for the costs of investigating a taxpayer’s fraud and for other losses caused by the fraud. Helvering v. Mitchell, 303 U.S. 391, 401 (1938); McGee v. Commissioner, 61 T.C. 249 (1973), *aff’d*, 519 F.2d 1121 (5th Cir. 1975). However, section 6663 is also designed “to punish and deter wrongful conduct.” Asphalt Industries, Inc., 384 F.2d at 234-35. Given the policy of punishing and deterring wrongful conduct, it would be improper to impose the fraud penalty based solely on the preparer’s misconduct; the wrongful conduct of the preparer should not have an adverse affect on an innocent taxpayer. This is especially the case because the Code includes specific provisions that are intended to deter fraud or other misconduct on the part of return preparers. *See, e.g.*, sections 6694, 6695, 7206, and 7216. Thus, because the same definition of “fraud” applies for purposes of the fraud penalty and for purposes of the statute of limitations, proof of the return preparer’s fraudulent intent in preparing the tax return is insufficient to make section 6501(c)(1) applicable to Taxpayer.

Several arguments have been raised in support of using the fraud of the return preparer as the basis for holding the statute of limitations open, but we do not find these arguments persuasive. First, the argument is made that the fraud of one spouse is sufficient to make section 6501(c)(1) applicable to both spouses. *See, e.g.*, Vannaman v. Commissioner, 54 T.C. 1011 (1970); Estate of Upshaw v. Commissioner, 416 F.2d 737 (7th Cir. 1969); Howell v. Commissioner, 175 F.2d 240 (6th Cir. 1949). In effect, one spouse’s fraudulent intent is imputed to the other spouse and it is argued that the return preparer’s intent may similarly be imputed to Taxpayer. However, we reject this analogy. The analogy is not helpful because each spouse generally has joint and several liability on a joint return. In contrast to the husband/wife scenario, the return preparer is not a party to the return and the return preparer is not jointly liable with Taxpayer.

Second, the argument is made that fraudulent intent on the part of corporate officers and employees may, in certain situations, be imputed to the corporation and the statute of limitations thereby kept open on the corporate return based on the fraud of the officers and employees. *See* Ruidoso Racing Association, Inc. v. Commissioner, 476 F.2d 502 (10th Cir. 1973), *aff'g* T.C. Memo. 1971-194. This analogy is not helpful in resolving the present issue. A corporation is an artificial person that acts through its employees, officers, and directors. Grant v. Commissioner, T.C. Memo. 1994-161. Thus, in order to prove that a corporate return was fraudulent, the intent of the corporation's officers and employees must necessarily be considered. By contrast, an individual taxpayer may act independently of the return preparer, and the taxpayer's intent may differ from that of the return preparer. The focus in proving fraud must therefore be on the individual's intent, rather than the preparer's intent. This is true whether the issue of fraud arises in the context of the fraud penalty or the fraud exception to the three-year statute of limitations.

We conclude that in the present situation section 6501(a) is applicable. Section 6501(c)(1) does not by its express language require that the "intent to evade tax" be the personal intent of Taxpayer. We nonetheless conclude that the fraudulent intent of the return preparer is insufficient to make section 6501(c)(1) applicable.

Please call if you have any further questions.

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