DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

March 30, 2001

OFFICE OF
CHIEF COUNSEL

Number: **200126019**
Release Date: 6/29/2001
CC:PA:APJP:Br2
WTA-N-100807-01
UILC: 6501.05-00, 6501.05-01, 6501.05-07, 6663.00-00.

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: ASSOCIATE AREA COUNSEL (SB/SE)
Area 2 - Richmond
CC:SB:2:RCH

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

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

This Chief Counsel Advice responds to your memorandum dated October 27, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice is not to be used or cited as precedent.

LEGEND

Taxpayer =
Firm =
Preparer =

ISSUE

Whether I.R.C. § 6501(c)(1) applies to the commission of fraud with intent to evade tax in the preparation of a return by the agent of a taxpayer?

CONCLUSION

Section 6501(c)(1) provides an exception to the general 3-year period of limitations in the case of a fraudulent return with the intent to evade tax. By its terms, section 6501(c)(1) applies with respect to any fraudulent return with intent to evade tax. Neither section 6501(c)(1) nor its legislative history suggest that a taxpayer can avoid the consequences of its agent's fraudulent conduct. Therefore, we conclude that the fraudulent intent of the taxpayer's agent provides 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 Preparer) was able to obtain huge tax refunds for truck drivers based on their diesel fuel purchases. Taxpayer sought out the services of Preparer for tax years

Preparer 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. Preparer 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 determined against Taxpayer. However, the Service proposes to rely on the fraud of Preparer as a defense to the argument that the period of limitations for assessing deficiencies has expired.

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 as follows:

> 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 conclusion stated above follows from the language of the statute and applicable principles of statutory construction. The statute phrases the exception to the period of limitations in terms of a fraudulent return with intent to evade tax without requiring fraudulent intent on the part of the taxpayer. There is no suggestion in the statute, the regulations, or the legislative history that the exception does not apply to fraud committed by the agent of the taxpayer under general principles of agency law. Also, 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). Statutes of limitation on assessment of tax are no exception. Lucia v. United States, 474 F.2d 565, 570 (5th Cir. 1973).

Moreover, the rationale underlying the fraud exception to the period of limitations on assessment applies with the same force to fraud by the taxpayer's agent as it does to fraud by the taxpayer. A fraudulent return places the Service at a special disadvantage in discovering and ascertaining the correct tax liability. By its very nature, a fraudulent return generally appears correct on its face and the true facts concerning the tax liability are deliberately withheld from the Service. As noted in

Badaracco v. Commissioner, supra, "fraud cases ordinarily are more difficult to investigate than cases marked for routine tax audits. Where fraud has been practiced, there is a distinct possibility that the taxpayer's underlying records will have been falsified or even destroyed." 464 U.S. at 398. Moreover, "three years may not be enough time for the Commissioner to prove fraudulent intent." 464 U.S. at 399. To compensate for the burden imposed on the Service of having to prove fraudulent intent and ascertain the correct tax liability, section 6501(c)(1) provides the Service with an unlimited time in which to ascertain the correct tax liability and establish the facts necessary to prove that the return is fraudulent. Only in this way can the Government's interest be protected. Given the underlying purpose of section 6501(c)(1), it does not matter whether the fraud is that of the taxpayer or the taxpayer's agent. In either situation, the Service is disadvantaged by the fraud.

We do not believe that our conclusion that fraud by an agent falls within the exception of section 6501(c)(1) requires that we reach the same conclusion with respect to the penalty for fraud under section 6663. We do not dispute that the same definition of fraud applies for purposes of section 6501(c)(1) and section 6663. However, the focus of the fraud inquiry differs for these two sections because only section 6663 is penal in nature. Congress intends section 6663 "to punish and deter wrongful conduct." Asphalt Industries, Inc. v. Commissioner, 384 F.2d 229, 234-35 (3d Cir. 1967), rev'g 46 T.C. 622 (1966). In contrast, the purpose of section 6501(c)(1) is to preserve the ability of the government to assess the correct tax liability in a situation where the return was prepared in a manner calculated to conceal that liability. Congress logically could, and we believe Congress did, intend the focus of a fraud inquiry to be different in these two sections. Thus, we conclude that fraud exists for purposes of section 6501(c)(1) when a taxpayer's agent commits fraud, even though the fraud penalty may not be imposed based solely on the fraud of the taxpayer's agent.

The distinctive policy rationales underlying section 6663 and section 6501(c)(1) are illustrated by the treatment of fraud on a joint return. The courts have consistently held that the fraud of one spouse on a joint return holds the period of limitations open as to both spouses. For period of limitations purposes it is immaterial whether the fraud is that of the husband, the wife, or both. See Estate of Upshaw v. Commissioner, 416 F.2d 737 (7th Cir. 1969); Estate of Ginsberg v. Commissioner, 271 F.2d 511 (5th Cir. 1959); Howell v. Commissioner, 175 F.2d 240 (6th Cir. 1949); Vannaman v. Commissioner, 54 T.C. 1011, 1018 (1970). The rationale is that section 6501(c)(1) is "an impersonal provision applying to the situation arising from a fraudulent return." Weinstein v. Commissioner, 33 B.T.A. 105, 107 (1935). Just as it does not matter which spouse is responsible for the fraud on a joint return, it should also not matter for period of limitations purposes whether the fraud is that of the taxpayer or the taxpayer's agent.

By contrast, the fraud penalty imposed by section 6663 is not an impersonal provision. The fraud penalty is intended to deter wrongful conduct and should be

imposed only on the wrongdoer. This is why the predecessor to section 6663(c) was enacted in 1971 as part of the original "innocent spouse" legislation (Pub. L. No. 91-679 (1971)). Prior to the enactment of this provision, the fraud penalty could be imposed on both spouses even though only one spouse had the requisite fraudulent intent. The case law was based on the principle of joint and several liability on a joint return. In enacting the predecessor of section 6663(c), Congress created an exception to that principle because imposition of the fraud penalty against the nonfraudulent spouse resulted in injustice. H.R. Rep. No. 1734, 91st Cong., 2d Sess. (1970); S. Rep. No. 1537, 91st Cong., 2d Sess. (1970). When explaining the reasons for the legislation, the Senate Finance Committee stated that "[t]his proposal seeks to correct the unfairness in the situations brought to the attention of this committee and to bring government tax collection practices into accord with basic principles of equity and fairness." S. Rep. No. 1537, 91st Cong., 2d Sess., at 2 (1970). Thus, if one spouse does not participate in the fraud, the fraud penalty should not be imposed against that spouse. Similarly, if a taxpayer does not contribute to the fraudulent conduct of its agent in preparing the taxpayer's return, section 6663 should not apply. The legislative history underlying the predecessor of section 6663(c) makes clear the distinction between the fraud penalty and the fraud exception to the usual 3-year period of limitations. Congress carved out an exception to the principle of joint and several liability on a joint return to prevent imposition of the fraud penalty on an innocent spouse, but left intact the prior case law under which the period of limitations is kept open as to both spouses even if only one spouse committed the fraud. Thus, the statement was made that "[t]he bill does not alter the rules with respect to the statute of limitations." S. Rep. No. 1537, at 4, 91st Cong., 2d Sess. (1970). The analogy to fraud on a joint return thus provides support for the conclusion that Preparer's conduct in preparing a false return with an intent to evade tax keeps the period of limitations open even though Preparer's conduct is insufficient to subject Taxpayer to the fraud penalty.

Further, nothing in the legislative history of section 6501(c)(1) casts doubt on the foregoing analysis. The "intent to evade the tax" language was added to a predecessor of section 6501(c)(1) in 1918. The legislative history does not suggest that Congress intended for the "intent to evade the tax" to be the personal intent of the taxpayer. There is no logical or policy reason to suppose that Congress intended that taxpayers would be able to avoid the fraud exception where their agents committed fraud on their behalf. See H.R. Rep. No. 1037, 65th Cong., 3d Sess., at 61 (1919); 57 Cong. Rec. 304 (1918).

Finally, an examination of the principles of agency law is helpful in resolving the present issue. The Tax Court has held that "fundamental agency law provides that the actions of the tax preparer (agent) are imputed to the taxpayer (principal)." Caulkins v. Commissioner, T.C. Memo. 1984-504. In Caulkins, the taxpayer should have attached a particular form to his income tax return in order to make an election to depreciate certain assets using the half year convention, but the return preparer failed to prepare the requisite form. The Tax Court held that when a

taxpayer signs and thereby adopts a tax return prepared by a return preparer, the taxpayer bears the consequences of errors made by the return preparer.

When a principal puts an agent in a position that enables the agent, while apparently acting within his authority, to commit a fraud upon third persons, the principal is liable to third persons for the fraud. See Restatement (Second) of Agency § 261. The rationale underlying this rule is that from the point of view of the third party, the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business for which he was engaged. See Rutherford v. The Rideout Bank, 11 Cal.2d 479, 80 P.2d 978 (1938) (bank held liable for fraudulent misrepresentations by bank manager designed to benefit the manager and not the bank).

Applying agency principles to the present situation, Preparer was Taxpayer's agent. As Taxpayer's agent, Preparer committed a fraud upon the government that benefitted Taxpayer directly at the expense of the government. Taxpayer must bear responsibility for the actions of Preparer.

In reaching the conclusion stated above, we have considered and rejected several contrary arguments. First, we note that the fraud exception to the period of limitations and the fraud penalty were at one time included in the same section of the revenue acts. See Revenue Act of 1918, sections 250(b) and (d) and Revenue Act of 1921, sections 250(b) and (d). Based on the principle of statutory construction that identical words used in different parts of the same statute are generally interpreted in the same way, an argument can be made that the term "fraud" has the same meaning under sections 6501(c)(1) and 6663 and that under both sections the focus of the fraud inquiry is restricted to the taxpayer's intent and activities. See Estate of Cuddihy v. Commissioner, 32 T.C. 1171 (1959) (citations omitted). While we believe that the elements of fraud are the same under sections 6501(c)(1) and 6663, this does not mean that under both sections the focus of the inquiry is restricted to the taxpayer's activities and intent. In determining whether section 6501(c)(1) applies, the return preparer's activities and intent must also be considered. Also, for many years the fraud exception to the period of limitations and the fraud penalty have no longer been contained within the same statutory provision. This indicates that the principle of statutory construction noted above may not apply now even if it arguably applied in the past. Thus, the focus of the fraud inquiry need not be restricted under both sections to the taxpayer's activities and intent.

Second, the Tax Court has on several occasions stated that the definition of fraud for purposes of section 6501(c)(1) is the same as the definition of fraud under section 6663. Neely v. Commissioner, 116 T.C. No. 8 (2001); Rhone-Poulenc Surfactants and Specialties, LP v. Commissioner, 114 T.C. 533 (2000); 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)).

However, none of the cases in which this statement was made involve the issue now presented. We do not dispute that the same definition of fraud applies for purposes of section 6501(c)(1) and section 6663. The distinction that must be made is in terms of the focus of the fraud inquiry. The focus in section 6501(c)(1) is on whether fraud was committed in connection with the return, while the focus in section 6663 is on whether the taxpayer committed the fraud.

Third, court opinions frequently include language to the effect that fraud is never imputed. See Payne v. Commissioner, 224 F.3d 415, 420 (5th Cir. 2000). Although cases which stand for the proposition that fraud is never imputed may seem contrary to the conclusion we have reached in this case, the present case is distinguishable. Those cases addressed a question of evidence or proof, namely, whether the taxpayer's fraudulent intent can be imputed or presumed from the facts and circumstances. By contrast, the present case involves the legal issue of whether fraud exists where someone other than the taxpayer has the intent to defraud the government. In the present case there is no need to impute fraud from Preparer to Taxpayer, as section 6501(c)(1) does not require that the "intent to evade tax" be the personal intent of Taxpayer.

Fourth, we recognize that the "badges of fraud" used by the courts in determining the existence of fraud have been applied 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. The "badges of fraud" are: (1) understatement of income; (2) inadequate records; (3) failure to file tax returns; (4) implausible or inconsistent explanations of behavior; (5) concealing assets; and (6) failure to cooperate with tax authorities. See Bradford v. Commissioner, 796 F.2d 303, 307 (9th Cir. 1986). However, the issue presented in this case was not involved in any of the cases applying the "badges of fraud." Thus, the application of the "badges of fraud" is not appropriate in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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If you have questions, please contact Susan L. Hartford at (202) 622-4940.

CURTIS G. WILSON
By: Michael L. Gompertz,
Assistant to the Branch Chief
Branch 2