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No extended assessment period for innocent S shareholder

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The Office of Chief Counsel (OCC) advised in Chief Counsel Advice (CCA) 201238026 that the assessment period is not extended for the personal tax liability of a shareholder who did not take part in the fraud reflected on his S corporation's Form 1120S, *U.S. Income Tax Return for an S Corporation*.

Sec. 6501(a) generally requires the IRS to assess any tax within three years after a return is filed by a taxpayer. One of several exceptions to the three-year assessment period is Sec. 6501(c)(1), which provides for an unlimited assessment period in the case of a false or fraudulent return with the intent to evade tax. Generally, the statutory requirement of an intent to evade tax looks at the intent of the taxpayer who filed a return. However, there are several exceptions, such as cases involving spouses filing joint returns (where both spouses are liable for deficiencies by virtue of the joint filing) or TEFRA unified partnership proceedings.

As explained in the CCA, shareholders A and B were equal owners of an S corporation engaged in the business of roofing, remodeling, and repairing buildings. The corporation often hired subcontractors to perform work for customers, and the subcontractors billed the corporation for their work.

In addition to working for the corporation, some subcontractors worked for shareholder B personally. Shareholder B instructed these subcontractors to record false job site addresses of the corporation's customers on their invoices rather than his personal address, where the work had been performed. He also changed the address on other personal invoices from his own to those of the corporation's job sites. His actions caused many personal expenses to be falsely recorded as business expenses on the corporation's books and deducted on its tax return. This resulted in an understatement of the S corporation's income that passed to shareholders A and B and was reported on their personal tax returns.

Shareholder B was convicted of various tax crimes, including fraud and filing false individual and corporate tax returns. Shareholder A did not sign the S corporation's tax return, nor did he participate in the preparation of the return. There was also no evidence that he was aware of shareholder B's fraudulent activities. Consequently, the Small Business/Self-Employed Division attorney sought advice from the OCC as to whether shareholder A's personal return could be assessed a tax deficiency, given that it had been filed approximately 10 years earlier.

Case law has established that the mere act of reporting fraudulently understated income from an S corporation on the personal return of a shareholder does not automatically make the shareholder guilty of fraud. Instead, to determine whether an unlimited assessment period is appropriate, the IRS must examine the activities of each shareholder. According to the CCA, this is similar to the way the assessment statute has been applied to spouses. Fraud by one spouse holds the assessment period open for the other spouse only when the spouses file a joint return, not when they file separate returns.

Because shareholders A and B filed separate tax returns and the fraudulent amounts reflected on shareholder A's return did not arise from his actions, the OCC advised that the general three-year assessment period applied to his return. Any assessment of deficient tax on that return consequently was barred.

The OCC's reasoning in the CCA does not apply to partners. Under Sec. 6229 (c)(1), partners that sign or participate in the preparation of a partnership return containing a false or fraudulent item with the intent to evade tax are subject to an unlimited assessment period. Partners who do not sign or participate in the preparation of such a return but who report their share of a partnership's fraudulent income on their own returns are subject to a six-year assessment period. While application of these rules to shareholder A's situation would not have altered the outcome (his return had been filed more than six years earlier), partnerships are subject to unified audit procedures that do not apply to S corporations.

The OCC's conclusion contrasts with the position of the IRS in *Allen*, 128 T.C. 37 (2007), where the Tax Court agreed with the IRS and held that an income tax return preparer's fraud extended indefinitely the assessment period of a taxpayer's personal tax liability, even when the taxpayer did not intend to evade tax. Instead, the OCC's reasoning is more in keeping with the IRS's recent loss in *City Wide Transit*, T.C. Memo. 2011-279 (appeal docketed). In that case, the Tax Court determined that although the taxpayer's accountant engaged in various tax crimes including filing false returns for the taxpayer, the false filings were incidental consequences of the accountant's scheme to embezzle from the taxpayer, not willful attempts to evade taxes.

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