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TAX MATTERS

Proving fraud proves difficult for IRS

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The Tax Court determined that the IRS was time-barred from assessing tax against the owner of several bankrupt entities for all but the last of several years at issue. Aside from the one year for which the taxpayer consented to extend the limitation period, the assessments were all outside the regular three-year period, and the unlimited limitation period for assessment did not apply because the returns were not fraudulent. The Tax Court did, however, impose an accuracy-related penalty for the open year, finding that the taxpayer failed to make a good-faith effort to assess the proper tax liability.

In 1984, after defaulting on bank loans, Theodore Gould and several entities in which he held interests filed voluntary Chapter 11 bankruptcy petitions. The bankruptcy court approved a consolidation plan, providing, among other things, for the establishment of a liquidating trust to which all assets of the bankruptcy estate were to be transferred. The plan was silent, however, on the trustee's obligation to file tax returns or to pay taxes. To clarify this matter, the bankruptcy court subsequently determined that the liquidating trust was a grantor trust and not a taxable entity. On appeal, the Supreme Court reversed this determination, holding that the trust was not a grantor trust and that the trustee was responsible for filing returns and paying taxes (*Holywell Corp. v. Smith*, 503 U.S. 47 (1992), rev'g 911 F.2d 1539 (11th Cir. 1990), aff'g 85 B.R. 898 (Bankr. S.D. Fla. 1988)). The trustee, nonetheless, did not file timely returns for the taxpayer, leading to an IRS examination.

After remitting more than $6 million to the IRS, the trustee of the liquidating trust entered into a compromise and settlement agreement that provided for an additional $10 million payment. The agreement also stated that there would be no tax attribute carryovers available to Gould's bankruptcy estate. In 1998, the liquidating trust was terminated, and the bankruptcy cases of Gould and the entities were closed.

On joint tax returns for 1995–2002, Gould reported net operating loss (NOL) deductions, capital loss deductions, and estimated tax payments belonging to the liquidating trust and one of the entities. Gould claimed that he succeeded to his bankruptcy estate's NOLs upon its termination. But he did not report his distributive share of income generated by one of the entities. He also did not remit any of the estimated tax payments reported on the joint tax returns. And while he did amend some of the returns to report self-employment tax liabilities, he did not remit those amounts, either. The IRS subsequently disallowed the NOL and capital loss deductions and assessed a civil fraud penalty under Sec. 6663(a) for each year or, alternatively, an accuracy-related penalty under Sec. 6662(a) for 2002 (for which Gould agreed to extend the limitation period).

Sec. 671 provides for grantors who are treated as the owner of a trust to take into account all items of trust income, deduction, and credits when computing their personal income tax. Sec. 1398(i) allows a debtor who succeeds to the property of a bankruptcy estate upon its termination to take into account many of the tax attributes of the estate, including NOLs and capital losses.

Sec. 6501(a) generally requires the IRS to assess any tax within three years after a return is filed or due. 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. Where the issue of fraud with intent to evade tax is raised in a noncriminal proceeding, the IRS must show by clear and convincing evidence that the taxpayer had an underpayment of tax and that at least some portion of the underpayment was due to fraud.

Gould argued that, based on the bankruptcy court's holding, the IRS was collaterally estopped from asserting that he was not the grantor of the liquidating trust. The Tax Court, however, rejected that argument because of the Supreme Court's reversal. The court then noted that the settlement agreement expressly provided for no carryover of tax attributes. Thus, the court determined that Gould was not entitled to take into account the trust's NOLs in computing his taxable income. Additionally, the court rejected the claimed capital loss deductions for lack of substantiation. As a result, the court sustained the IRS's determination that Gould had underpayments of tax for the years at issue.

The Tax Court then reviewed the "badges of fraud" factors traditionally analyzed to determine fraudulent intent. Gould failed to keep adequate records, and his explanation of why he claimed losses but did not report income from one of the entities strongly indicated his intent to evade tax. But he cooperated with tax authorities and disclosed on his returns the reasons for claiming credit for unpaid taxes. Thus, the court determined that the IRS failed to clearly prove fraudulent intent. The unlimited assessment statute consequently did not apply, and the IRS's determinations for 1995–2001 were time-barred.

For 2002, the open year, the court upheld the IRS's disallowance of claimed NOL and capital loss deductions. It also found that Gould was not entitled to credit for payments made to the IRS by the liquidating trust. Last, the court determined that the accuracy-related penalty was applicable because Gould failed to prove that he had acted with reasonable cause in claiming the disallowed deductions or that he had a reasonable basis for his reporting positions.

- *Gould*, 139 T.C. No. 17 (2012)

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