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

OFFICE OF
CHIEF COUNSEL

October 30, 2001

Number: **200205027**
Release Date: 2/1/2002
CC:PA:APJP:Br2
TL-N-1287-01
UILC: 2513.00-00, 2513.03-00, 6501.05-00, 6501.05-01, 6501.05-07

INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR:	ASSOCIATE AREA COUNSEL - Area 1 (Large and Mid-Size Business) CC:LM:FSH:HAR
FROM:	Assistant Chief Counsel (Administrative Provisions & Judicial Practice) CC:PA:APJP
SUBJECT:	Fraud Exception to the 3 Year Period of Limitations

This Chief Counsel Advice responds to your memorandum dated March 12, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice is not to be used or cited as precedent.

LEGEND

Taxpayer =
Taxpayer's Husband =
Date 1 =
Date 2 =
Industry =
Year 1 =

ISSUE

Whether the fraud of Taxpayer's Husband in valuing a gift can be used as the basis for holding the period of limitations open pursuant to I.R.C. § 6501(c)(1) with respect to Taxpayer's gift tax return when Taxpayer's Husband and Taxpayer elect split gift treatment under I.R.C. § 2513.

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. We conclude that the fraudulent intent of Taxpayer's Husband will not, under the facts of this case, provide a sufficient basis for applying section 6501(c)(1) to Taxpayer's gift tax return.

FACTS

Prior to Date 1, Taxpayer's Husband owned 100% of an S corporation's issued and outstanding stock. Taxpayer's Husband is a highly sophisticated businessman and is well-known in the Industry for his knowledge of the Industry.

On Date 1, Taxpayer's Husband gifted 48% of his stock to his children. On Date 2, Taxpayer's Husband and Taxpayer timely filed separate gift tax returns (Form 709). Taxpayer's Husband hired a return preparer to prepare Forms 709 for himself and Taxpayer, and provided the return preparer false information as to the value of the stock. On each Form 709, Taxpayer's Husband and Taxpayer identically valued the aggregate shares and split the value in accordance with section 2513 of the Internal Revenue Code. On Taxpayer's Husband's Form 709, Taxpayer indicated her consent to the split gift. Similarly, Taxpayer's Husband indicated his consent to split the gift by signing Taxpayer's Form 709. Neither Taxpayer nor Taxpayer's Husband paid any gift tax on the split gift. More than three years have passed since the filing of the gift tax returns by Taxpayer and Taxpayer's Husband.

The Service maintains that the fair market value of the stock substantially exceeded the amounts reported on the gift tax returns of Taxpayer and Taxpayer's Husband. The Service proposes to issue notices of deficiency to Taxpayer and Taxpayer's Husband for Year 1 for the deficiencies in gift tax. The Service intends to assert the section 6663 fraud penalty against Taxpayer's Husband because the Service has determined that he intentionally undervalued the stock on his Form 709; the Service does not intend to assert the fraud penalty against Taxpayer, because the Service has no evidence establishing fraudulent intent on her part.

The period of limitations on assessment for Taxpayer's Husband's Year 1 gift tax liability remains open based on fraud despite the passage of more than three years from the filing of his gift tax return. I.R.C. § 6501(c)(1). The Service has raised the question of whether it may rely on the fraud of Taxpayer's Husband as a defense to the argument that the period of limitations for assessing deficiencies has expired with respect to Taxpayer's Year 1 gift tax liability.

Based on the factual development of this case to date, the Service has no reason to believe Taxpayer or anyone directly involved in the preparation of the return (e.g., the return preparer) had any knowledge of the fraudulent undervaluation. We suggest that you consider the possibility of further factual development in this regard.

LAW AND ANALYSIS

Section 2502(c) provides that gift tax shall be paid by the donor. As an exception to the general rule, section 2513(a)(1) provides that if the spouses each consent, a gift made by one spouse to any person other than his spouse shall be considered as made one-half by him and one-half by his spouse. Consequently, both spouses will be treated as the donor under section 2513(a) and each is obligated to pay any resulting gift tax liability. By consenting to split gift treatment under section 2513(a)(2), the entire gift tax liability of each spouse for that tax year is joint and several. I.R.C. § 2513(d); Treas. Reg. § 25.2513-4.

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, 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." I.R.C. § 6501(c)(1).

To determine whether section 6501(c)(1) applies to Taxpayer's return, an understanding of the concept of "fraud" is necessary. Neither the Code nor the Treasury regulations provide a definition of "fraud." However, the Tax Court has indicated that "[w]hen the Commissioner alleges that a taxpayer filed a false and fraudulent return with the intent to evade tax, the Commissioner must prove that the taxpayer (1) underpaid income tax and (2) filed the tax return with the specific intent to evade a tax believed to be owed." Chin v. Commissioner, T.C. Memo. 1994-54 (citing Sec. 6501(c)). In addition, the Service has defined tax fraud "as an intentional wrongdoing on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing." I.R.M. 104.2.1.2.0(2) (emphasis added). Thus, a return that contains both an underpayment of tax and a fraudulent intent on the part of the taxpayer is a "fraudulent return."

You note that section 6501(c)(1) phrases the fraud exception to the usual 3-year period of limitations in terms of a fraudulent return with intent to evade tax and does not explicitly require fraudulent intent on the part of the taxpayer. 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) (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).

A fraudulent return places the Service at a special disadvantage in discovering and ascertaining the fraud and this disadvantage is present whether the fraud is that of Taxpayer or Taxpayer's Husband. 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. You argue that this rationale applies whether the fraud is that of Taxpayer or Taxpayer's Husband.

In the present case, Taxpayer's Husband filed his own gift tax return, but he is not a taxpayer with respect to Taxpayer's return. Nor is Taxpayer's Husband a return preparer or an agent of Taxpayer acting in a capacity similar to that of a return preparer. Further, because the present case involves joint and several tax liability, you have drawn an analogy between the present case and court cases holding that the fraud of one spouse on a joint income tax return holds the period of limitations on assessment open as to both spouses. Ballard v. Commissioner, 740 F.2d 659, 663 (8^{th} Cir. 1984) ("section 6501(c)(1) lifts the statute of limitations on tax assessments against both spouses when they file jointly and one has defrauded the government in the process"). See also Estate of Upshaw v. Commissioner, 416 F.2d 737 (7^{th} Cir. 1969), aff'g T.C. Memo. 1968-123; Howell v. Commissioner, 175 F.2d 240 (6^{th} Cir. 1949), aff'g 10 T.C. 859 (1948); 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).

In addition to joint and several liability, other factors may suggest an analogy between this case and the joint return situation in the cases cited above. Each Form 709 in this case contains the signatures of both spouses; the consent of Taxpayer's Husband is signified on line 18 of Taxpayer's return, and the consent of Taxpayer is signified on line 18 of Taxpayer's Husband's return. See Treas. Reg. § 25.2513-2(a)(1)(i). Further, the instructions to Form 709 instruct the spouses to mail their Forms 709 in the same envelope.

We conclude, however, that this case cannot be analogized to court cases holding that the period of limitations on a joint income tax return remains open as to both spouses when only one has committed fraud. Those cases may be distinguished as follows. In the income tax context, there are two taxpayers reporting a single tax liability on one return. This liability is computed based on the aggregate incomes, deductions, exemptions, and credits of the spouses. Under section 6013(d)(3), each spouse is jointly and severally liable for the liability. If one spouse commits fraud, the joint return is thereby rendered fraudulent and the period of limitations remains open as to both taxpayers under section 6501(c)(1). Because there is only one tax liability and one tax return, a different period of limitations cannot apply to each spouse.

In contrast, in the split gift tax context, there are two taxpayers, each of whom reports a separately computed gift tax liability on a separate return. Depending on each spouse's available unified credit and annual exclusion amounts, their overall gift tax liabilities for the year may not be equal. The husband is not a taxpayer with respect to the wife's return, and the wife is not a taxpayer with respect to the husband's return. We think it is of crucial importance that Taxpayer's return is not a joint return notwithstanding the possible analogy to the present case and a situation involving a joint income tax return. See True v. United States, 354 F.2d 323, 326 (Ct. Cl. 1965) ("[j]oint returns are not part of the procedure for the collection of the gift tax").

Thus, in this case, Taxpayer's return is not rendered fraudulent simply because the return of Taxpayer's Husband is fraudulent; two separate liabilities and two separate returns are involved and, therefore, an analysis of whether section 6501(c)(1) applies to Taxpayer's return must be separate from the analysis of whether section 6501(c)(1) applies to Taxpayer's Husband's return.

In the present situation, the Service determined the actual fair market value of the stock to be substantially higher than the value reported on Taxpayer's return. This results in a deficiency in Taxpayer's gift tax liability. This underpayment of tax was not the result of Taxpayer's intent to defraud the government. Based on the factual development of this case to date, the Service has no reason to believe Taxpayer or her agents in preparing the return (e.g., the return preparer) had any knowledge of Taxpayer's Husband's fraudulent undervaluation. Moreover, Taxpayer had no reason to suspect that Taxpayer's Husband had committed fraud in undervaluing the stock. Thus, Taxpayer's return is not a "fraudulent return" because it does not reflect a fraudulent intent on the part of Taxpayer or her agent.

In Jackson v. Commissioner, T.C. Memo. 1964-330, aff'd, 380 F.2d 661 (6th Cir. 1967), cert. denied, 389 U.S. 1015 (1967), the Tax Court held that when a husband and wife file separate income tax returns, proof that a husband's return is fraudulent is not clear and convincing evidence that a wife's return for the same tax year is also fraudulent. We believe a similar rule applies in a gift tax context where spouses file separate returns for split gifts. Absent information indicating that Taxpayer knew that Taxpayer's Husband gave the return preparer fraudulent information about the value of the gifted stock, we do not believe that the Service could prove fraud by Taxpayer by clear and convincing evidence. See I.R.C. § 7454.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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