THE TAX ADVISER

A MAGAZINE OF PLANNING, TRENDS & TECHNIQUES

JULY 1992

Tax Preparation Software

An Invaluable Tool That Should Be in Every Practitioner's Future

Penalties for Tax Fraud Against a Corporation

Unlike the IRS, the Courts Understand That Not All Acts Committed in a Corporation's Name Are Corporate Acts

Valuation of Closely Held Businesses

Estate and Gift Tax Issues

Computers in Taxation

■ Laser printed smart forms.

Studies in Taxation

■ Merging partnerships for tax savings.

Thumbtax

■ PALs ■ One class of stock ■ Tax benefit rule.

Tax Trends

■ Home deduction while receiving exempt living allowance ■ Sale between partnership and corporation owned by same individuals ■ Residence transferred, but occupied by decedent until death.

Tax Clinic

■ Separate deduction for retirement plan expenses ■ Nonqualified stock option and research credit ■ Phaseout of itemized deductions for individuals claiming FTC ■ Treatment of start-up costs after INDOPCO ■ Statement of allowable loss for consolidated group members ■ Computerized record retention rules ■ Effects of CERT rules ■ Texas franchise tax ■ Insolvency and changes in ownership ■ AMT and claim of right ■ Accruals to related foreign persons ■ S corporation planning for FTCs ■ OID for foreign holders on debt retirement ■ Ramifications of affiliates providing services ■ Form 990-PF for nonoperating private foundations ■ Sec. 467 rental agreements ■ New estimated tax rules ■ Tender offer as option for NOL purposes ■ Alternate partnership test for economic effect.

THE TAX ADVISER

A PUBLICATION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

JULY 1992

ARTICLES

419 Tax Preparation Software
BY TERESE WATERS

Tax preparation software has come a long way since the days of the remote service center. In the 1990s, tax preparation software is more user friendly, providing both tax return preparation aids and tax law reference aids. Tax preparation software has expanded so far that some preparation programs include on-line tax reference guides, such as CCH's Master Tax Guide, IRS instructions, and special interactive worksheets designed to lead even a novice through a complicated tax transaction. The technology of tax processing is changing rapidly. As with other software, practitioners may no longer have the benefit of three or more years to reap the benefits of the learning curve. Instead, they may need to expand training efforts to get staff members "up and running" faster.

464 Penalties for Tax Fraud Against a Corporation
BY SHELDON D. POLLACK

Civil and criminal penalties for tax fraud are an imposing weapon wielded by the IRS against taxpayers. At a minimum, the taxpayer against whom civil tax fraud is asserted by the IRS will confront a liability for penalties that may turn out to be nearly as great as the tax claimed to be owed. If criminal charges are asserted, the taxpayer will face the possibility of imprisonment and fines on top of all the other penalties otherwise provided for under the Code. A corporation may face a particularly bad situation when a "responsible person" (e.g., a key employee, controlling shareholder, officer or director) causes the corporation to commit a fraud, and the IRS asserts tax fraud penalties against the corporation.

471 Valuation of Closely Held Businesses
BY JAMES R. HITCHNER

The valuation of a closely held business for estate and gift tax purposes requires a thorough analysis to substantiate the value that is ultimately determined. Since closely held businesses do not have publicly traded price quotes listed on one of the major exchanges or over the counter, their valuation is that much more complex. The difficulty in valuing a closely held company can be compounded by the fact that many closely held companies are much smaller than their publicly traded counterparts. However, if the valuation practitioner is cognizant of the areas in which a smaller closely held company may differ, appropriate adjustments can be made during the valuation process.

Opinions expressed in *The Tax Adviser* are those of the individual writers and may differ from policies of the American Institute of Certified Public Accountants, the Tax Division or its other divisions and committees.

This publication is designed to provide accurate and authoritative information on the subjects covered. It is sold, however, with the understanding that the publisher, editors and authors are not engaged in rendering legal, accounting or other professional service. If specific tax advice or other expert assistance is required, the services of a competent professional person should be sought.

The contents of *The Tax Adviser* are indexed in the AICPA publication *Accountants' Index*, and in the online database *Accountants*, available on the ORBIT Search Service System.

Penalties for Tax Fraud Against a Corporation

Unlike the IRS, the Courts Understand That Not All Acts Committed in a Corporation's Name Are Corporate Acts

Sheldon D. Pollack, Ph.D., J.D.
Shaiman, Phelan & Schwartz, P.C.
Philadelphia, Penn.

Civil and criminal penalties for tax fraud are an imposing weapon that can be used against taxpayers. At a minimum, the taxpayer against whom civil tax fraud is asserted by the IRS will confront a liability for penalties that may turn out to be nearly as great as the tax claimed to be owed. If criminal charges are asserted, the taxpayer will face the possibility of imprisonment and fines on top of all the other penalties otherwise provided for under the Code.

This article will discuss the daunting tax fraud situation commonly confronted by corporate taxpayers.

The Corporate Entity

A corporation is a legal and taxable entity separate and distinct from the individuals who own or manage it. Because a corporation can act only through its agents, when a "responsible person" of a corporate taxpayer (e.g., a key employee, controlling shareholder, officer or director) causes the corporation to commit a fraud, the IRS will often assert tax fraud against the corporation. (Of course, any such claims against the corporation will be in addition to those that may be brought against the individual.) However, in many cases the individual's motivation in causing the corporation to commit an illegal act is to hide his own fraudulent acts, such as the misappropriation of corporate funds (for instance, through embezzlement or the use of corporate funds for the individual's own personal benefit). The perpetrator may falsify the corporation's books and records to disguise fraudulent payments to himself or enter false payments for nonexistent purchases, etc., thereby causing the corporation to file a false tax return by understating income or overstating expenses. In such circumstances, assertions of tax fraud against the corporation may appear as if the IRS is vindictively pouring salt on a wound already inflicted on the corporation by its own fiduciary.

While the IRS will routinely assert tax fraud against a corporation based on such acts committed by a responsible person, the likelihood of the Service actually prevailing in litigating this position in court is less certain. Indeed, in some jurisdictions, there is case law suggesting that the corporate taxpayer may be able to successfully defend itself against such claims.

Civil Tax Fraud

The Omnibus Budget Reconciliation Act of 1989 (OBRA) substantially modified the statutory scheme for the civil fraud penalty, providing a somewhat less complex structure that is better integrated with the other civil penalties. Under pre-OBRA law, the fraud penalty was embodied in former Sec. 6653(b), applicable to returns due before Jan. 1, 1990. For 1990 and later years, the fraud penalty is imposed under Sec. 6663. Under Sec. 6663(a), the fraud penalty is imposed at the rate of 75% of that portion of the underpayment attributable to fraud.[1]

Author's note: The author wishes to thank Anne O'Connell Umbrecht for her significant contributions to an earlier version of this article.

[1] OBRA Section 7721(a).

■ Establishing fraud

Neither old Sec. 6653 nor new Sec. 6663 defines "fraud" for purposes of the civil fraud penalty. Instead, the definition is found only in case law. Under that case law, to prevail in establishing fraud, the IRS must show by clear and convincing evidence that the taxpayer "intended to evade taxes which it knew or believed it owed, by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes."[2] To establish a penalty for fraud, the Service must show that the taxpayer intended to evade taxes that it knew or believed to be owed.[3] One commentator has summarized the factors necessary to support a charge of tax fraud.

☐ The end to be achieved—the payment of less tax than that known by the taxpayer to be legally due.

☐ An accompanying state of mind that is variously described as being "evil," "in bad faith," "deliberate and not accidental" or "willful."

☐ An overt act aimed to achieve the nonpayment of taxes known to be due.[4]

The courts have continually reiterated that fraud will not be "imputed or presumed."[5] Mere suspicion of fraud is insufficient, nor can a finding of fraud be based on a taxpayer's failure to carry its burden of proof as to the underlying deficiency. Instead, the IRS must prove fraud by clear and convincing proof, and a preponderance of the evidence is not enough to sustain that burden of proof.[6] The courts find fraudulent intent by reviewing "the taxpayer's entire course of conduct and draw[ing] reasonable and appropriate inferences therefrom."[7] The indicia on which a court can draw reasonable inferences of fraud may be compiled from the case law.

☐ A substantial understatement of income and a pattern of such understatement over several years.

☐ Failure to keep adequate (or any) books and records, particularly when the taxpayer is an intelligent and experienced business person.

☐ Extensive dealings in cash.

☐ Destruction or alteration of financial records.

☐ Failure to turn over to an accountant all information necessary to prepare accurate income tax returns.

☐ A guilty plea.[8]

The mere presence of indicia of fraud is not enough to sustain the IRS's burden of proof, although the Service can satisfy its burden by circumstantial evidence.[9]

The OBRA further clarified prior law by providing that the taxpayer must establish the items not attributable to fraud by a preponderance of the evidence.[10]

■ Fraud by a corporation

Fraud can be established against an individual based only on his own actions. However, because a corporation is a separate "artificial" legal entity, "special rules" apply in determining liability for tax fraud.[11] Under special facts and circumstances, fraud can be asserted against a corporation based on the actions of a responsible person. Obviously, the IRS must first prove that the actions and intentions of the employee, officer, shareholder or director were willful and motivated by the requisite "evil" intent. Assuming that this can be established, the question becomes under what circumstances can the actions and intentions of the individual be imputed to the corporation itself.

In the case of tax fraud, the wrongful acts and intentions of a responsible person will be imputed to the corporation itself only under limited circumstances.[12] According to the Tax Court, "corporate fraud exists if either: (1) the corporate agent so controls the corporation that the corporation becomes the agent's alter ego, or (2) the agent is acting in behalf of the corporation with the result that the corporation actually benefits from the

---

[2] *M.J. Laputka & Sons, Inc.*, TC Memo 1981-730, at 81-2858–81-2859, citing *Chris D. Stoltzfus*, 398 F2d 1002 (3d Cir. 1968)(22 AFTR2d 5251, 68-2 USTC ¶9499), *cert.* denied.

[3] *William E. Mitchell*, 118 F2d 308 (5th Cir. 1941)(26 AFTR 684, 41-1 USTC ¶9317).

[4] Balter, *Tax Fraud and Evasion*, 5th ed. Boston: Warren, Gorham & Lamont, 1983, at ¶2.01[1].

[5] *Arc Electrical Construction Co.*, TC Memo 1988-592, at 88-3068, citing *Anson Beaver*, 55 TC 85, 92 (1970).

[6] *Est. of Leo G. Federman*, TC Memo 1952-206.

[7] *Laputka*, note 2, at 81-2859, citing *Charles E. Mitchell*, 303 US 391 (1938)(20 AFTR 796, 38-1 USTC ¶9152). See also *M. Rea Gano*, 19 BTA 518, 533 (1930).

[8] *Laputka*, note 2, at 81-2859.

[9] *C.S. Day*, TC Memo 1965-326.

[10] Sec. 6663(b). The IRS still has the initial burden of proving fraud by clear and convincing evidence, a higher burden of proof than that imposed on the taxpayer. See H. Rep. No. 101-247, 101st Cong. 1392 (1989).

[11] *Arc Electrical*, note 5, at 88-3069.

[12] *Irving S. Federbush*, 34 TC 740 (1960), aff'd *per curiam* on other issues, 325 F2d 1 (2d Cir. 1963)(12 AFTR2d 6069, 64-1 USTC ¶9107); *Auerbach Shoe Co.*, 21 TC 191 (1953), aff'd, 216 F2d 693 (1st Cir. 1954)(46 AFTR 1083, 54-2 USTC ¶9673).

agent's fraudulent acts."[13] The courts have uniformly applied the Tax Court's two-part test, one part of which *must* be satisfied before the fraudulent actions of an officer, shareholder or director will be attributed to the corporation.

Alter ego: Under the first part of the test, to satisfy its burden, the IRS must prove that the corporation was the "alter ego" of the individual whose actions are at issue.

Tax Court case law suggests that a significant degree of stock ownership, control or domination of the corporate entity by a shareholder, officer or director is required in order to find it to be the alter ego of such individual. The conditions for such a degree of control are more likely to be present in wholly owned or very closely held family corporations. Even there, it is difficult for the IRS to establish that the degree of actual control or domination was sufficient to support a finding that the corporation was the individual's alter ego.

For example, in *Ruidoso Racing Association, Inc.*,[14] the Tax Court found that a corporation's chief executive officer (CEO) who owned or controlled 62% of the taxpayer's stock did not so dominate the corporation as to make the corporation his alter ego when his control of the corporation was inhibited by the fact that he was only one of three members of the board of directors, his full exercise of control might have jeopardized the corporation's relations with a governmental authority, and his potential for taking money out of the corporation was limited insofar as almost 40% of any dividend would go to the other stockholders. Thus, the Tax Court (and the Tenth Circuit on appeal) held that the corporation was *not* the CEO's alter ego. However, the court nevertheless found the corporation liable for the fraud penalty because the CEO was found to have acted in behalf of the corporation *and* the fraud benefited the corporation by overstating deductions from gross income.

In general, cases in which fraud was successfully established on the basis of the officer, director or shareholder being the alter ego of the corporation have involved wholly owned or very closely held corporations in which the shareholder, officer or director exercised nearly exclusive control over the corporate entity.[15]

Agency and benefit to corporation: Because of the difficulty in establishing that a corporation is the alter ego of any particular individual, most cases will probably turn on the second part of the Tax Court's test—namely, that (1) the individual, whether alone or in concert with others, acted as "agent" for or "in behalf of" the corporation *and* (2) the corporation actually benefited from the individual's acts.

☐ *Agency:* In most cases, the IRS argues that because a corporation can act only through its officers and directors, they necessarily must be "agents" of the corporation or acting in behalf of it and, thus, their intentions should be imputed to the corporation.[16] However, a review of the case law suggests that the IRS has been successful in litigating its position *only* when there was a clear convergence of interests between the corporation and the individual who committed the particular acts at issue. The IRS prevailed when the individual was a sole or dominant shareholder of the corporate taxpayer and, hence, it was possible to establish principles of agency or that the individual acted in behalf of the corporation. As several courts have perceptively noted, in such circumstances the individuals are merely "taking their own money."[17]

For example, in *Arc Electrical Construction Co.*,[18] the Tax Court imposed the fraud penalty on the corporation as a result of a scheme that involved the diversion of corporate funds for the personal benefit of majority shareholders. Arc was

[13] *Arc Electrical*, note 5, at 88-3069. See also *Ruidoso Racing Ass'n, Inc.*, 476 F2d 502 (10th Cir. 1973)(31 AFTR2d 73-1069, 73-1 USTC ¶9330), aff'g in part and rem'g in part TC Memo 1971-194. Accord *Miracle Span Corp.*, N.D. S.D., 1982 (50 AFTR2d 82-5334, 82-1 USTC ¶9365); *Botwinik Brothers of Mass., Inc.*, 39 TC 988 (1963), at 996.

[14] *Ruidoso Racing*, id.

[15] See, e.g., *Laputka*, note 2, in which the CEO *owned 60%* of the corporation's stock and diverted corporate funds for personal use, the 40% minority shareholder was found negligent in not discovering the scheme and the CEO was found to have actually controlled and dominated the corporation. See also *Hub Cloak & Suit Co., Inc.*, TC Memo 1956-196 (the president/treasurer majority shareholder was *found to dominate* the corporation); *Ace Tool & Engineering, Inc.*, 22 TC 833 (1954); *Federbush*, note 12.

[16] See, e.g., *Federbush*, note 12, TC, at 749; *Ace Tool & Engineering*, id., at 843; *George M. Still, Inc.*, 19 TC 1072, 1077 (1953); *The Saven Corp.*, 45 BTA 343, 355 (1941).

[17] *Botwinik Brothers*, note 13, at 996, quoting *Ace Tool & Engineering*, note 15, at 841–842.

[18] *Arc Electrical*, note 5.

a closely held family business whose board consisted of the daughters of the chairman and their husbands. The secretary/treasurer diverted funds through false petty cash vouchers, bonuses and charges of personal expenses as business expense. These practices benefited 69% of Arc's shareholders and Arc itself. (Arc's taxable income decreased as a result of overstated expense deductions and unreported income and the diverted funds ended up in the pockets of a majority of the shareholders.) Therefore, the court imputed the directors' intent and actions to the company and imposed the fraud penalty on the company.

Similarly, in *Frankland Racing Equipment, Inc.*,[19] the majority shareholder (who was also a director) conspired with the other corporate directors to divert corporate income to their personal accounts. They used a bookkeeping procedure designed to circumvent the regular corporate bookkeeping method so no one else in the company was aware of their scheme. The court found that the majority shareholder dominated the corporation, and acted in behalf of it, and that the corporation benefited because the fraud lowered the corporate taxable income. As a result, the corporation was held liable for the fraud of its directors.

In *M.J. Laputka & Sons, Inc.*,[20] two brothers owned 100% of the company stock. One brother was the chief executive officer and owned 60% of the stock; the other provided legal advice to the company and owned 40% of the stock. The CEO created a system under which clients were overbilled and excess payments were diverted into two personal accounts. The court noted that "[a] corporation is taxable on monies it receives from transactions authorized by it or within the scope of its corporate activities, or where it has command over the monies received."[21] Because the clients received corporate invoices, mailed payments made out to the corporation at the corporate offices, and believed that the CEO acted in the corporation's behalf, the corporation was held liable for the consequences of the scheme. The court also found the corporation liable because the CEO controlled and dominated it. The court noted that the 40% shareholder was negligent in not discovering the scheme. Therefore, in sanctioning the fraud penalty against the corporation, the court justified indirectly sanctioning the 40% shareholder.

When a 100% shareholder commits the fraudulent acts, it is considerably easier for the IRS to establish that the shareholder acted in behalf of the corporation (although it still must be established that the corporation benefited from the acts).[22] When the "agent" is a minority shareholder, the corporate taxpayer may prevail by arguing that even if the offending individual is an officer or director, that individual acted *ultra vires*—specifically, contrary to his fiduciary duties and outside the scope of authority to the extent that corporate funds are diverted for the sole benefit of such individual and the corporation does not know of, approve or ratify such diversion.[23]

If this argument is successful in showing that the responsible person acted *ultra vires*, it will be difficult for the IRS to prove that the individual was acting as "agent" or "in behalf" of the corporation when his actions were unknown and unauthorized by the corporation and were in breach of the fiduciary duties incumbent on an officer/director.

☐ *Benefit to corporation:* As noted above, under the second part of the test, in order to successfully establish the fraud penalty, the IRS must also show that a corporation benefited from the fraudulent acts of the person who acted as agent or on behalf of the corporation.

It is easy to grasp the logic of the courts in finding a benefit to the corporation and/or a majority of its shareholders when the fraudulent acts resulted in cash or property being diverted to their pockets, thereby reducing the corporate level taxation by virtue of the income going unreported at the corporate level. This was the case in *Arc Electrical, Frankland Racing, Laputka, Ruidoso Racing, Coleman, Truesdell, Cosmopolitan Credit,* and other cases in which a majority (and as many as 100%) of the shareholders took part in, knew

[19] *Frankland Racing Equipment, Inc.*, TC Memo 1987-210.
[20] *Laputka*, note 2.
[21] *Laputka*, id., at 81-2852, citing *Union Stock Farms*, 265 F2d 712 (9th Cir. 1959)(3 AFTR2d 952, 59-1 USTC ¶9317).

[22] See, e.g., *Philip G. Coleman*, TC Memo 1988-538; *James Vernon Truesdell*, 89 TC 1280 (1987); *Cosmopolitan Credit Corp.*, TC Memo 1972-103; *Bennett E. Meyers*, 21 TC 331 (1953). See also *Braxton H. Taylor*, TC Memo 1989-261.
[23] See *Peter R. Corbin v. Mark M. Corbin*, 429 F Supp 276, 281 (M.D. Ga. 1977); *Rochez Brothers, Inc. v. Rhoades*, 527 F2d 880, 884 (3d Cir. 1975).

of, and/or benefited from the fraud, thereby resulting in a monetary benefit to themselves and reduced corporate level tax.

However, in other cases, the courts have recognized that the corporation was the innocent victim of unauthorized activities perpetrated against the corporation itself and a majority of its shareholders. In these cases, the courts have found that the acts of the shareholder/employee were adverse to the interests of the corporation and, thus, refused to impose the fraud penalty on the corporation. For instance, in *Botwinik Brothers of Mass., Inc.*,[24] a minority shareholder in charge of the company's books misappropriated funds from the company. The majority shareholders and other officers were unaware of the misappropriation and fired the perpetrator on discovery. The fact that the fraudulent acts were committed by a minority shareholder "whose interests were adverse to those of the corporation and the majority stockholders" was crucial to the court's finding that the corporation was a "victim of her wrongful conduct" and not liable for the fraud.[25]

The *Sherin*[26] case involved a scheme in which the president, who owned half of the company's stock, received payments in excess of federal price ceilings for the goods produced by the company. The president provided preferential treatment to the customers who paid the premium. The funds were used for the president's personal benefit. The court reasoned that because the president was not a controlling or majority shareholder and the other shareholder knew nothing about the plan, the president's actions could not be characterized as those of the corporation. The corporation was not authorized to collect the illicit payments and, therefore, there was no income to the corporation. Because the corporation did not have "command over the income," it was not taxed on the income and not liable for a fraud penalty.[27]

There is considerable support for corporate taxpayers based on a frequently cited Third Circuit case, *Asphalt Industries, Inc.*[28] Asphalt Industries was a Pennsylvania corporation owned 50% by Anderson and 50% by Schwoebel. Anderson, Schwoebel and an employee comprised the board of directors. Anderson was the president and devoted full time to the corporation; Schwoebel was secretary-treasurer and devoted most of his time to another business. Anderson diverted corporate funds to his own use by keeping some sales receipts off the corporation's books and endorsing and cashing corporate checks issued in payment of the hidden sales. The Tax Court held, and the Third Circuit did not disagree, that Anderson's intent was fraudulent.

The Tax Court further held that Anderson's fraudulent intent should be imputed to the corporation since he was acting in behalf of, and not against, the interests of the corporation. The Third Circuit reversed on this issue. The court held that in deciding whether Anderson's conduct should be attributed to the corporation, it must be "guided by general principles of corporate responsibility" and "the usual rules of principal and agent." The court stated:

> To permit the officers of a corporation to conduct its affairs is presumably to intend that they shall conduct them honestly and within the limits of their corporate duty. It does not constitute an authorization to embark upon fraud against others, much less against the inactive stockholder himself.[29]

The court's refusal to find fraud was apparently based on a finding that Anderson was acting outside the scope of his authority as a corporate officer. The opinion indicates that the result would have been different if the other shareholder had accepted benefits from Anderson's acts or engaged in conduct "leading others to rely upon an authority which does not in fact exist." However, in the court's view, Schwoebel was an "innocent" investor who was not Anderson's "creature" and could not be deemed to have acquiesced in what Anderson did. Schwoebel was "as much defrauded as was the Treasury and it would be piling additional injury upon an innocent stockholder to require that the corporation in which he invested should bear the burden of assessments based upon the fraud which Anderson committed in the name of the corporation as a subordinate element in his need to conceal his embezzlement of its funds."[30]

Obviously, in many cases any tax "benefit" to the corporation will be more than offset by the

[24] *Botwinik Brothers*, note 13.
[25] *Botwinik Brothers*, id., at 997.
[26] *Harry Sherin*, 13 TC 221 (1949).
[27] See also *All Americas Trading Corp.*, 29 TC 908 (1958).
[28] *Asphalt Industries, Inc.*, 384 F2d 229 (3d Cir. 1967)(20 AFTR2d 5357, 67-2 USTC ¶9620), rev'g 46 TC 622 (1966).

[29] *Asphalt Industries*, id., 3d Cir., at 67-2 USTC 85,046.
[30] *Asphalt Industries*, id., 3d Cir., at 67-2 USTC 85,047.

significantly greater economic loss suffered at the hands of the perpetrator. The economic benefit would go only to the perpetrator, the tax benefit to the corporation, and the net detriment (i.e., the diverted cash less the benefit of the tax deduction) would be borne by the innocent shareholders. Under such circumstances, it should be difficult for the IRS to convince the Tax Court that the acts of the perpetrator were to the "benefit" of the corporation and/or a majority of its shareholders.

Likewise, if the other directors of the corporation did not know of or approve of the acts of the perpetrator (and the other shareholders likewise did not approve of the acts), and if the alleged acts were contrary to the corporation's interests, the perpetrator could not be acting in his capacity as "agent" of the corporation or acting in its behalf. Indeed, such acts would be *ultra vires* and adverse to the interests of the corporation and its shareholders.[31]

Criminal Tax Fraud

Many of the facts and circumstances in civil tax fraud will also give rise to criminal sanctions. Of course, there are significant differences between civil and criminal charges relating to such issues as the burden of proof (beyond a reasonable doubt in criminal cases) and the procedure by which a charge is brought (e.g., approved by the Justice Department's Tax Division and prosecuted by the Criminal Section). While a detailed discussion of criminal sanctions is beyond the scope of this article,[32] it is worthwhile to summarize some of the comparable issues that arise when a corporation is held liable for criminal tax fraud based on the illegal acts of an employee, officer, director or shareholder.

■ Code provisions

Criminal tax fraud charges are typically brought under Secs. 7201 and 7206 (in addition to all the other non-Code criminal statutes). Sec. 7201(a) provides for sanctions against

> [a]ny person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof. . . .

Sec. 7206(1) provides for sanctions against any person who

> [w]illfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter. . . .

Obviously, the same fact patterns previously discussed (e.g., a responsible pĕrson of a corporation causes the corporation to file a fraudulent return to disguise his own misappropriation of corporate funds) can also give rise to sanctions under either of these criminal provisions.[33]

In addition to the criminal sanctions brought against the corporation, Sec. 7343 provides that a "person" chargeable with tax fraud includes "an officer or employee of a corporation . . . under a duty to perform the act in respect of which the violation occurs." This means that the responsible person who commits the willful act that leads to the charges against the corporation may also be personally liable under Sec. 7343. This liability is in addition to any related charges that may arise on account of the perpetrator filing a fraudulent individual tax return (for instance (as commonly is the case) for failure to report the misappropriated or embezzled corporate funds as income or as a constructive "dividend").

While raising many of the same issues as are confronted in the civil context, the criminal charges will be more severe and may be imposed in addition to any civil penalties brought against the corporation. Indeed, one commentator has concluded: "As a matter of fact, it is reasonably certain that civil fraud penalties will be imposed after a taxpayer has been convicted, and, even if the taxpayer is fortunate enough to obtain an acquittal, the issue of fraud penalties in a civil case will probably have to be faced." (Footnote omitted.)[34] Thus, many of the same issues may be retried in subsequent civil proceedings even if criminal charges are successfully defended by the corporation.[35]

---

[31] In a recent case, *In re American Biomaterials Corp.*, 3d Cir., 1/23/92, aff'g unreported DC decision, the Third Circuit relied on its prior holding in *Asphalt Industries*. However, the court noted that notwithstanding its rule in *Asphalt Industries*, if a corporation is lax in its internal controls or fails to secure competent external auditors, it can be held liable for statutory penalties.

[32] See Balter, note 4, at Chapter 11. See also Hochman, Guterman, Wilson, Scholl and Zuckerman, 449 T.M., *Tax Crimes—Corporate Liability* (1988); IRM 4231, Chapter 900 et seq. ("Fraud").

[33] See IRM [4231] 921(1).

[34] Balter, note 4, at ¶11.01[1].

[35] See, e.g., *O.D. Cain*, TC Memo 1971-45, aff'd, 460 F2d 1243 (5th Cir. 1972)(29 AFTR2d 72-1115, 72-1 USTC ¶9422). See, generally, Balter, note 4, at ¶8.01 and ¶11.01[1]. See also *George Arconti*, TC Memo 1970-215.

■ Acts of officers, directors, shareholders

In general, a corporation is held liable for the criminal acts of a responsible person when the acts are committed in an official capacity, are to the benefit of or in furtherance of the corporation and are authorized (or acquiesced in) by the corporation.[36] These requirements raise much the same issues as were discussed regarding civil penalties. One of the most frequently litigated issues has concerned the degree of "willfulness" that must be present to establish violations under the Code's criminal tax fraud provisions.[37] The Government's difficulty in proving "willfulness" on the part of a responsible person is often the reason why criminal charges are not brought against a corporation in the first place.

Many of the same defenses discussed in the context of civil sanctions are raised in the case of criminal sanctions brought against a corporation based on the willful acts of a responsible person. Specifically, defenses include establishing that (1) the corporation did not know of or acquiesce in such acts; (2) the corporation did not benefit from the illegal acts (and most likely was injured by such acts); or (3) the acts were not committed in the responsible person's capacity as an employee, officer or director.

[36] *American Radiator & Standard Sanitary Corp.*, 433 F2d 174 (3d Cir. 1970), *cert.* denied; *George S. Carter*, 311 F2d 934 (6th Cir. 1963), *cert.* denied; *Standard Oil Co. Texas*, 307 F2d 120 (5th Cir. 1962); *Empire Packing Co.*, 174 F2d 16 (7th Cir. 1949), *cert.* denied.

[37] In *John L. Cheek*, Sup. Ct., 1991 (67 AFTR2d 91-344, 91-1 USTC ¶50,012), the Supreme Court considered the element of "willfulness" under Sec. 7201, the criminal fraud statute. See also *Cecil J. Bishop*, 412 US 346 (1973)(32 AFTR2d 73-5018, 73-1 USTC ¶9459).

Conclusion

While the IRS will readily assert the penalty for tax fraud against a corporation based on the actions of an officer, director or shareholder, the case law suggests that courts will affirm such a charge only under certain facts and circumstances. Indeed, this is the correct approach; there should be no rule imposing strict liability on a corporation. The perpetrator's position in the corporation, the effect on the corporation and its shareholders, the knowledge and/or participation in the fraud by other shareholders and officers, and the intentions of the guilty party all are, and should be, relevant to whether the fraud should be imputed to the corporation.

The idea that a corporation, as a fictional legal entity, can act only through its officers and directors should not obscure the fact that not all acts committed in the name of a corporation are corporate acts per se. Cases in which the corporation knows of, ratifies or acquiesces in the fraudulent acts of a responsible person are distinguishable from those in which the corporation and its shareholders (or at least a majority of them) have been victimized by their own fiduciary. In the latter cases, assertion of the penalty for tax fraud against the guilty individual alone should adequately serve the important purpose of protecting the Federal fisc. TTA