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## TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

### *IRS Misconduct: What Happens When the IRS Cheats at Trial?*

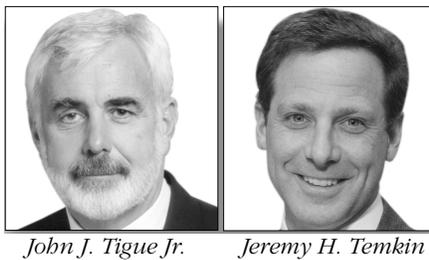
**W**HILE LITIGATION abuses by the Internal Revenue Service are rare, when misconduct by a government attorney comes to light, it raises a variety of serious questions. In a criminal case, misconduct may result in the appellate reversal of an ill-gotten conviction or the granting of habeas corpus relief if the defendant can leap the procedural hurdles designed to protect convictions.

But what recourse does a taxpayer have when faced with civil litigation misconduct by the IRS? Some courts have imposed monetary discovery sanctions<sup>1</sup> and applied equitable estoppel against the IRS,<sup>2</sup> but such instances are rare. Some jurisdictions have also recognized, in principle, that a Tax Court judgment procured through “fraud upon the court” may be reopened, even years after it was entered.

But such relief is largely theoretical, given that courts have almost invariably found that litigation misconduct fails to rise to the level of fraud on the court.

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Recently, however, the Ninth Circuit may have breathed new life into the “fraud on the court” doctrine, vacating a Tax Court decision in *Dixon v. Commissioner of Internal Revenue*,<sup>3</sup> based on its finding that the IRS attorneys handling that tax shelter litigation had engaged in a fraud that was plainly designed to corrupt the truth-seeking process.

#### ‘Dixon’

The misconduct in *Dixon* arose in the context of Tax Court proceedings brought by approximately 1,800 taxpayers for a redetermination of deficiencies resulting from the disallowance of personal income tax deductions they had claimed which were generated through a tax shelter operated in the 1970s and 1980s. The IRS and most of the taxpayers agreed to proceed by way of a “test-case” trial of seven taxpayers (two chosen by the petitioners and five chosen by the IRS) the outcome of which would be binding on the remaining tax-

payers. The IRS prevailed at that trial, obtaining a decision that the taxpayers were liable for all assessed deficiencies.

Following the trial, it came to light that unknown to the court, most of the taxpayers and their attorneys, prior to the trial the IRS’s trial counsel and his immediate supervisor had entered into secret settlement agreements with two of the test-case representatives whose subsequent testimony was decidedly adverse to the taxpayers at trial. One of those agreements reduced the taxpayer’s deficiency by more than 90 percent, generating a substantial refund for the express purpose of paying his legal fees. That taxpayer was the only one of the shelter participants to deliver the crucial testimony that he believed that the debt instruments generating the claimed deductions would not be enforced. The other taxpayer with whom the IRS had entered into a secret contingent settlement agreement was one of the representatives selected by the petitioners. The IRS lawyer also agreed to reduce his deficiency, and that taxpayer proceeded to trial pro se after the IRS persuaded him that based on the settlement he did not need counsel.

When senior IRS officials learned of these secret settlements, they brought the matter to the Tax Court’s attention and sought an evidentiary hearing to

determine the extent of the damage. Remarkably, despite what the U.S. Court of Appeals for the Ninth Circuit characterized as the commissioner's "telling case of corruption of the process of the Tax Court and the rights of both the government and the taxpayers,"<sup>4</sup> the Tax Court denied the commissioner's motion to vacate without even conducting an evidentiary hearing, concluding that its findings concerning the sham nature of the tax shelters were unaffected by the impropriety revealed by the commissioner. Finding that the taxpayers, the government and the Tax Court had all been cheated by the misconduct of the IRS attorneys, the Ninth Circuit vacated the Tax Court decision and remanded for a hearing to determine whether the misconduct rose to the level of a "structural defect voiding the judgment as fundamentally unfair, or whether, despite the government's misconduct, the judgment [could] be upheld as harmless error."<sup>5</sup>

After conducting the requisite hearing on remand and making extensive findings that the government's gross misconduct had occurred and had "diluted the adversarial nature" of the presentations to the Tax Court,<sup>6</sup> that same court concluded that the resulting error was harmless and reinstated the judgments against the taxpayers, albeit relieving them of certain increased penalties for interest, negligence and tax-motivated transactions and imposing costs and attorney's fees upon the IRS.

### **Wrong Legal Standard**

In a brief and pointed opinion, the Ninth Circuit found that the Tax Court had applied the wrong legal standard when it imposed on the taxpayers the requirement that they show some

prejudice as a result of the misconduct. Citing *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*,<sup>7</sup> it held that prejudice is not an element of fraud on the court, which occurs, and requires vacating or amending an affected decision when misconduct "harms the integrity of the judicial process, regardless of whether the opposing party is prejudiced." The Court of Appeals expressed exasperation with the IRS for wasting the opportunity to present its case fairly and properly and doing little to punish the misconduct in this case or to deter future abuse, as well as with the Tax Court for twice failing to resolve this situation equitably. Finding that the taxpayers should not be forced to endure another trial and that the IRS should be sanctioned, it opted neither to remand the case for yet another trial nor to completely eradicate all tax liability for the taxpayers. Instead, the court ordered that all of the petitioners be granted settlements on the same highly favorable terms as those secretly afforded one of the testifying taxpayers.

The Ninth Circuit's decision in *Dixon* is noteworthy not merely because of the depth of the misconduct at issue, but because of the court's willingness to take the steps necessary to remedy that misconduct. Not only did the *Dixon* taxpayers have to weather a delay of more than a decade between the IRS's disclosure of its attorneys' misconduct and the Ninth Circuit's ultimate decision in their favor, but they also avoided or overcame three significant hurdles that have prevented other taxpayers from prevailing in their efforts to reopen Tax Court judgments.

### **Setting Aside Decisions**

In *Dixon*, both the Tax Court and the Ninth Circuit accepted without extended discussion (or opposition from

the IRS) that the Tax Court had the authority to vacate or modify its initial judgment based on fraud upon the court. The Tax Court looked, by analogy, to the "savings clause" of Federal Rule of Civil Procedure 60(b), which provides that nothing in that rule, addressing the grounds and the time limitations for motions for relief from a final judgment, limits the power of a court to set aside a judgment for "fraud upon the court." In addition, both courts relied heavily on *Hazel-Atlas Glass* and the Ninth Circuit's earlier decision in *Toscano v. Comm'r*,<sup>8</sup> for the proposition that the Tax Court had the inherent equitable power to vacate a judgment procured through fraud on the court. But the U.S. Court of Appeals for the Eighth Circuit has held that the Tax Court, as a court of limited jurisdiction, is not a court of equity and, thus, has no power to vacate a judgment even though it might have been procured through fraud.<sup>9</sup>

Other courts, including the U.S. Court of Appeals for the Second Circuit,<sup>10</sup> have found that the Tax Court, at least in principle, does possess the authority to reopen a judgment obtained through fraud. They have reconciled the Tax Court's limited jurisdiction with its ability to vacate a fraudulently procured judgment by reasoning that "a decision produced by fraud on the court is not in essence a decision at all, and never becomes final."<sup>11</sup> But if taxpayers in these jurisdictions tend to prevail on the threshold question concerning the court's authority, they almost invariably lose when it comes to showing that the alleged misconduct rises to the level of fraud on the court required to overturn a judgment.

Every court to consider the question has drawn a sharp distinction between ordinary fraud, and "fraud upon the court" as that term is used in Rule

60(b). Most have adopted some version of the formulation contained in Moore's Federal Practice, that "[f]raud upon the court should ... embrace only that species of fraud which does or attempts to, defile the court itself, or is a fraud perpetrated by officers of the court so that the judicial machinery can not perform in the usual manner its impartial task of adjudging cases."<sup>12</sup>

Taxpayers have found this narrow definition an almost insurmountable obstacle, with courts refusing to find that its machinery has been derailed by frauds that tend to affect the taxpayer alone. Thus, in *Senate Realty Corp. v. Comm'r*,<sup>13</sup> the Second Circuit refused to vacate a judgment based on a stipulation of settlement that the taxpayer's attorney was not authorized to execute. The court reasoned that although the settlement was unauthorized, because the attorney had not misrepresented the facts in issue and there was no evidence of improper motive or collusion with the IRS, the unauthorized settlement did not meet the narrow definition of fraud on the court.<sup>14</sup> Similarly, claims that a taxpayer's attorney had a conflict of interest have been viewed as mere fraud upon the taxpayer and not on the court, providing insufficient grounds for overturning a Tax Court judgment.<sup>15</sup>

## Prejudice

The U.S. Court of Appeals for the Seventh Circuit has read into the definition of fraud on the court an additional requirement that the fraud affect the outcome of the case — a requirement akin to the *Dixon* Tax Court's prejudice requirement that the Ninth Circuit found erroneous. Relying on earlier decisions from the Tax Court, the Seventh Circuit in *Drobny v. Comm'r* held that a petitioner seeking

to vacate a Tax Court decision must show "an intentional plan of deception designed to improperly influence the Court in its decision has had such an effect on the court."<sup>16</sup> Under this approach, the court found no error in the Tax Court's refusal to vacate a judgment notwithstanding allegations that the IRS attorney had had improper ex parte communications with the judge hearing the case and that witnesses had been intimidated by counsel into withholding testimony for the IRS. The court found that even if the attorney for the IRS had engaged in improper threats against potential witnesses, it would not have affected the outcome because even if the witnesses had testified, it would not have changed the judge's ruling.

Reasoning that the "[p]erpetrator of the fraud should not be allowed to dispute the effectiveness of the fraud after the fact,"<sup>17</sup> the Ninth Circuit in *Dixon* squarely rejected the argument that the taxpayers needed to demonstrate prejudice in order to obtain relief from the Tax Court judgment. All that was required was a showing that the integrity of the Tax Court proceedings were undermined by the fraud. It noted that although the "Tax Court believed that it was hearing a legitimate adversarial dispute, ... in fact, the proceeding was a charade fraught with concealed motives, hidden payments, and false testimony." The court concluded that "[s]uch fraud corrupts the adversarial nature of the proceeding, the integrity of witnesses, and the ability of the trial court to judge impartially." This, coupled with the fact that the effects of the fraud extended not merely to the litigant before the court, but to all of the taxpayers who had agreed to be bound by the test case, provided clear and convincing evidence of fraud on

the court, entitling petitioners to relief.

While the Ninth Circuit's decision in *Dixon* takes a legal stand that strongly favors taxpayers confronted with injustice at the hands of the IRS, it remains to be seen whether the task of overturning a Tax Court judgment will be made appreciably easier after *Dixon*. Not only were the facts in that case extreme, but senior IRS officials were responsible for disclosing the misconduct, and the IRS did not seek to invoke procedural hurdles to shield its misconduct.

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(1) See, e.g., *United States v. Smith*, 55 FSupp 2d 917 (N.D. Ind. 1999).

(2) See, e.g., *Hunt v. United States*, 94 FSupp 2d 665 (D. Md. 2000).

(3) *Dixon v. Comm'r*, 316 F3d 1041 (9th Cir. 2003) ("*Dixon II*")

(4) *Dufresne v. Comm'r of Internal Revenue*, 26 F3d 105 (9th Cir. 1994), cert. denied, 514 US 1036 (1995).

(5) *Id.*

(6) *Dixon v. Comm'r*, 1999 WL 171398, at 93 (U.S. Tax Ct. March 30, 1999) ("*Dixon I*").

(7) 322 US 238 (1944), overruled on other grounds by, *Standard Oil v. United States*, 429 US 17 (1976).

(8) 441 F2d 930 (9th Cir. 1971).

(9) See e.g., *Jefferson Loan Co. v. Comm'r*, 249 F2d 364 (8th Cir. 1957). See also *Webbe v. Comm'r*, 902 F2d 688 (8th Cir. 1990).

(10) See, e.g., *Senate Realty Corporation v. Comm'r*, 511 F2d 929 (2d Cir. 1975).

(11) See, *Drobny v. Comm'r*, 113 F3d 670 (7th Cir. 1997), quoting *Kenner v. Comm'r*, 387 F2d 689 (7th Cir.), cert. denied, 393 US 841 (1968).

(12) See, e.g., *Dixon II*; *Senate Realty*; *Drobny*.

(13) 511 F2d 929

(14) See also *Vanstone v. Comm'r*, 166 F3d 1202, unpublished decision, 1998 WL 907832 (2d Cir. Dec. 23, 1998);

(15) See, e.g., *Wizbowski v. Comm'r*, 12 F3d 1111, unpublished decision, 1993 WL 497200 (9th Cir. Nov. 29, 1993), citing, *Kenner v. Comm'r*, 387 F2d 689; *Anderson v. Comm'r*, 693 F2d 846 (9th Cir. 1979).

(16) 113 F3d at 678-9, citing *Murdock v. Comm'r*, 1996 WL 677505 (Tax Ct. 1996); *Chao v. Comm'r*, 1989 WL 53824 (Tax Ct. 1989).

(17) 316 F3d at 1046, citing *Hazel-Atlas*.

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