TAX FRAUD AND INFLATED CORPORATE EARNINGS: IS THERE AN ALTERNATIVE TO THE MISSING LEGISLATIVE FIX?

By Craig M. Boise

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On October 22, 2004, President George W. Bush signed the American Jobs Creation Act of 2004, which included several provisions aimed at curbing both corporate tax shelters and corporate tax avoidance. Boise finds that, an important provision of the Senate version of the legislation was unfortunately left on the conference committee cutting-room floor. That provision, a response to the wave of accounting scandals that have rocked the markets over the last few years, would have increased the penalty applicable to corporations that filed fraudulent income tax returns to disguise earnings inflation. Boise thinks that the existing penalty provisions impose fines so small that they are not likely to have any deterrent effect on that type of tax fraud. But he argues that even without the missing legislative remedy, the IRS is not without the means to combat tax fraud related to earnings inflation. This article argues that because tax refund claims are in essence equitable claims, the IRS may, and should, assert equitable defenses such as the doctrine of unclean hands to deny refund claims arising from the fraudulent inflation of income. To facilitate that process, the article proposes a simple administrative structure using the newly issued Schedule M-3 to the corporate tax return form and oversight of earnings inflation-related refund claims by the Joint Committee on Taxation.

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Introduction

On October 22, 2004, without ceremony or fanfare, President George W. Bush signed the American Jobs Creation Act of 2004, P.L. 108-357 (the Act). Although principally a response to the determination by the World Trade Organization that the U.S. extraterritorial income regime was an illegal trade subsidy, the Act included several provisions aimed at curbing corporate tax shelters and corporate tax avoidance in general. Unfortunately, a significant provision of the Senate version of the legislation was left on the conference committee cutting-room floor. That provision, which would have increased the penalty applicable to corporations filing fraudulent income tax returns, was a direct response to a problem...
highlighted by the wave of earnings inflation scandals that have rocked the markets over the last five years.6

As was well documented by the media, more than 50 major publicly traded corporations were under investigation for accounting fraud and other financial misdeeds in 2002 alone.7 Most of those companies admitted to fraudulently inflating income through accounting gimmicks or by simply reporting nonexistent income-producing transactions8 — and were required to restate their earnings.9 In several cases, the admission of earnings inflation was immediately followed by the filing of claims seeking refunds of hundreds of millions of dollars in federal income taxes paid on the nonexistent income.10 WorldCom,11 which created $11 billion in fictitious income through fraudulent accounting schemes,12 reportedly has collected nearly $300 million in tax refunds.13 Qwest Communications International Inc., HealthSouth, and Enron also reportedly considered or are considering filing refund claims for overpayments of income tax in similar circumstances.14 Although information on refund claims is difficult to obtain because of the confidentiality of federal income tax returns, there are no doubt many others.

Tax overpayments giving rise to refund claims usually result from legitimate disputes about the treatment of items of income, credit, or deduction. If too much tax is paid, the tax rules mandate that a refund be issued to the taxpayer almost automatically.15 Perhaps this process should apply to earnings inflation cases as well. Corporations that inflated their taxable income clearly paid more federal income tax than they owed. Moreover, a refund of the excess tax paid would provide an infusion of cash that could mitigate the damage caused by the underlying financial accounting fraud.16

However, there is something unsettling about opening up the federal coffers to pay hundreds of millions of dollars to corporations that “made the IRS an unwitting accomplice to . . . fraud.”17 These corporations were not compelled to pay the additional taxes in the first place, nor were those payments the result of an unfortunate error in calculating tax liability. Rather, the overpayments made by WorldCom, Enron, and others were intentional, and they were used to legitimize massive financial accounting frauds.18 Moreover, offending corporations almost certainly would have been content to allow the government to keep the tax overpayments had their financial accounting fraud gone undetected.19

It might be sufficient in such circumstances to grant the tax refund but exact a hefty penalty to deter future use of the tax system to mask accounting fraud. However, as will be seen, any penalties ultimately imposed under current rules would be only nominal. Thus, withholding refunds might be the only way to adequately penalize the tax fraud committed in earnings inflation cases.20 In any event, tax refund claims seeking to recoup


7See infra notes 37 to 47 and accompanying text.


10In connection with its emergence from bankruptcy, WorldCom changed its name to MCI.


12See Blumenstein et al., supra note 10. The $300 million reportedly collected by WorldCom is nearly as much as the total amount of tax refunds paid to all corporations in the state of Oregon in 2003. See Dept’ of the Treasury, Internal Revenue Service 2003 Data Book, Publication 55B (Table 8) available at http://www.irs.ustreas.gov/pub/irs-soi/03db086fx.xls (last visited December 30, 2004).

13See Blumenstein et al., supra note 10.

14See infra note 141 and accompanying text for a response to the “innocent investor” argument.


taxes paid on fraudulently inflated earnings seem essentially different from traditional tax refund claims, and the decision whether or not to grant them should be guided by different considerations.

This article proposes a solution to the problem based on the proposition that tax refund suits are in essence claims in equity—a proposition that has two important implications. First, the taxpayer filing a tax refund suit is not asserting a legal “right,” but rather is asking the court to impose a fair, just, and equitable “remedy”—namely, the refund of taxes paid in excess of what was due. Thus, a taxpayer is not automatically entitled to receive a tax refund. Second, the taxpayer’s refund claim is subject to a well-established body of equitable principles, like the well-known general admonition that “those who seek equity must themselves do equity.” Consequently, in considering whether tax refunds should be granted in cases involving fraudulent earnings inflation, this article asserts that the IRS not only may but should assert equitable defenses to deny payment of those refunds.

Part I of the article examines the relationship between earnings inflation, book income, and tax income, based on the example of prominent offender WorldCom, and then assesses the significance of the earnings inflation phenomenon. Part II describes the current criminal provisions of the Internal Revenue Code that govern tax fraud related to earnings inflation and the elements of those crimes. One element in particular—materiality—raises the critical issue of whether inflation of taxable income causes any harm that should be penalized. This part of the article concludes that the government is harmed by tax fraud, that the penalty provisions for the crime are not sufficiently robust, in general, and that they are particularly inadequate in dealing with earnings inflation. Part II closes with a description of the tax refund process and the relative ease with which companies may obtain tax refunds, even when the excess taxes were intentionally paid to mask fraudulent earnings.

Part III of the article describes the relationship between fraud-related refund claims and equity. To provide support for the application of equity in that context as proposed in Part IV of the article, Part III first reviews the equitable nature of tax refund suits to establish that equity is an appropriate vehicle for evaluating tax refund claims. That part of the article then discusses the equitable defense of unclean hands and how the defense might be asserted by the IRS in evaluating a tax refund claim like that of WorldCom’s. Finally, Part IV of the article proposes a simple administrative framework within which the IRS might equitably evaluate tax refund claims, using a recently revised schedule to the corporate income tax return form and the review powers of the Joint Committee on Taxation.

I. Earnings Inflation and Tax Reporting

A. WorldCom’s Story

Beginning in 1999 telecommunications giant WorldCom created roughly $11 billion in artificial income through various accounting devices, including prematurely releasing line cost reserves, capitalizing line costs


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that should have been expensed under generally accepted accounting standards,\(^25\) and making false revenue entries.\(^26\) The effect of WorldCom's earnings fraud was to allow the company to consistently hit analysts' expected revenue targets\(^27\) and thus bolster the price of its stock, until July 2002, when the company finally and spectacularly collapsed in bankruptcy.\(^28\) Although reporting artificial income to its shareholders clearly violated SEC and Exchange Commission rules, that was only one part of WorldCom's fraud. Like all U.S. companies, WorldCom was required to file a federal income tax return, and therefore it had to determine whether to continue to play out its earnings charade for a different audience — the IRS.

When WorldCom first elected to inflate the income it reported to shareholders in 1999, there were at least two ways it could have treated that additional income for purposes of federal income tax reporting. First, WorldCom could have chosen not to report the artificial income on its federal income tax return, thus avoiding any cash outlay for taxes on the income.\(^29\) That approach would have created a sizable gap between WorldCom's accounting, or book, income on one hand, and its taxable income on the other.\(^30\) To analysts who closely followed the company, that book-tax difference might well have indicated that WorldCom was either managing its earnings\(^31\)


\(^26\)WorldCom was perpetrating accounting fraud in several ways other than the methods mentioned here. See WorldCom, Inc., First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, Case No. 02-15533 at 110-17 (Bankr. S.D.N.Y.) (Nov. 4, 2002), available at http://news.findlaw.com/hdocs/docs/worldcom/thornburgh1st rpt.pdf (last visited December 30, 2004).

\(^27\)WorldCom CEO Bernard J. Ebbers allegedly insisted that the company provide financial numbers that met or exceeded analysts' expectations. See Indictment, United States v. Bernard J. Ebbers, supra note 23 at 7.

\(^28\)WorldCom Inc., Third Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, supra note 25 at 1. As a result of WorldCom's bankruptcy, more than $200 billion in shareholder value was destroyed and tens of thousands of WorldCom employees lost their jobs.

\(^29\)Under generally accepted accounting principles (GAAP), WorldCom would have been required to record additional deferred tax expense.

\(^30\)To be more precise, failing to report the artificial income would have increased, rather than created, a book-tax difference because WorldCom, like most companies, already would have had a book-tax difference.

\(^31\)Earnings management occurs "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to (Footnote continued in next column.) or had low earnings quality.\(^32\) A large book-tax difference also might have alerted the IRS to WorldCom's fraud.\(^33\) A market perception of earnings chicanery or intensified IRS scrutiny would have been disastrous to a company concealing billions of dollars of artificial income in the midst of an industry downturn, and those considerations may have resulted in the rejection of that approach.\(^34\)

Second, WorldCom could have elected (and, in fact, did elect) to report the inflated book earnings as additional taxable income on its corporate income tax return. For WorldCom the consequent drain on cash flow associated with payment of the additional tax apparently was outweighed by the secrecy it afforded. Reporting the income produced no additional book-tax difference to be reconciled on Schedule M-1 and no deferred tax expense, thus greatly reducing the likelihood that WorldCom's earnings inflation would be discovered. Before its fraud was exposed, WorldCom apparently was quite satisfied with the tax price it paid for its artificial earnings.\(^35\) In fact, it is possible that WorldCom actually used net operating loss carryforward deductions to offset some, if not all, of the additional taxable income.\(^36\)

\(^32\)See L. Mills and K. Newberry, "The Influence of Tax and Non-Tax Costs on Book-Tax Reporting Differences: Public and Private Firms," J. Am. Tax'n Ass'n 23 (Spring) at 1-19; P. Chaney and D. Jeter, "The Effect of Deferred Taxes on Security Prices," J. Acct. Audit & Fin. 9 (Winter) at 71-116. "Earnings quality" refers to the level of sustainability of a company's earnings. See S.A. Richardson, "Earnings Quality and Short Sellers," Accounting Horizons (Supp. 2003) at 49 (citing Z. Bodie et al., Investments (6th Ed. 2002) at 628 (quality of earnings refers to the "extent to which we might expect the reported level of earnings to be sustained"). Low-quality earnings could result from overvaluation of receivables, aggressive manipulation of reserves, or inappropriate valuation of inventory, and are characterized by an increase in current earnings without any corresponding increase in cash flows. Id.


\(^34\)In a variation on this approach, WorldCom could have shifted the artificial income to an offshore subsidiary in a low-tax jurisdiction, thus making the book-tax difference permanent and avoiding the recognition of a deferred tax liability. See American Institute of Certified Public Accountants, Accounting Principles Board Opinion No. 23, Accounting for Income Taxes - Special Areas (April 1972).

\(^35\)According to a recent study of firms that overstated accounting income and paid additional taxes as a result, the median firm was willing to pay an additional 8 cents in income taxes for each dollar of inflated pretax earnings. See Merle Erickson et al., "How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings," Acct. Rev. (Spring 2004).

\(^36\)A company that inflated earnings and thereby was able to use net operating loss carryforwards or carrybacks would not be entitled to a refund, but might seek to reinstate the NOLs.
WorldCom’s experience illustrates the impact that earnings inflation in a company’s financial accounts has on its tax accounting. A company that inflates earnings must either falsify its federal income tax return or face an increased risk that its earnings fraud will be detected. Thus, for many companies that inflate accounting earnings, tax fraud becomes a necessary component of the accounting fraud.

B. The Significance of the Problem

Unfortunately, WorldCom’s experience is not an isolated example.37 The significance of earnings inflation has grown dramatically in terms of its prevalence and, thus, its potential affect on the U.S. tax system. In 1999 the Committee of Sponsoring Organizations of the Treadway Commission (COSO)38 released a study analyzing the extent of financial statement fraud from 1987 through 1997. The commissioned study identified instances of such fraud by examining hundreds of accounting and auditing enforcement releases (AAERs), each of which is a summary of enforcement action taken against a public company by the Securities and Exchange Commission.39 The AAERs examined were limited to those reflecting a violation of the SEC rules most directly related to financial fraud.40 During the 11-year period studied, nearly 300 companies were involved in financial statement fraud. Of those 300 companies, 200 were randomly selected for closer examination. Although all of the companies were publicly traded, they tended to be relatively small (less than $100 million in total assets), and only 22 percent of the companies committing financial statement fraud were listed on the New York or American stock exchanges.41

Those numbers changed dramatically after 1997, however, according to a 2002 General Accounting Office report.42 The GAO study examined financial statement restatements announced by publicly traded companies that involved “accounting irregularities”43 during the period from 1997 through June 2002. More than half of the accounting irregularities resulted from “improper revenue recognition” or “cost or expense related issues.”44 The growth in the number of earnings restatements during the period studied was remarkable. By contrast to the 300 incidents of financial statement fraud in the 11-year period covered by the COSO study, the GAO study found that 225 companies restated earnings because of accounting irregularities in 2001 alone, with 250 projected for 2002. Between 1997 and June 2002, the number of companies restating earnings grew by 145 percent, with that growth expected to increase to 170 percent by the end of 2002.45 In other words, during the five-year period studied, roughly 10 percent of all listed companies announced a restatement of earnings arising from accounting irregularities, most of which involved the sort of fraud committed by WorldCom.46

Not only did the GAO study reflect an increase in the incidence of earnings restatements, it revealed a shift in the profile of companies restating earnings. After 1997 there was a significant rise in the number of large company restatements.47 Over the period examined by the study, the average (median) market capitalization of a restating company grew from $500 million in 1997 to over $2 billion in 2002. Moreover, of the 125 public companies that restated earnings because of accounting irregularities in 2002, 107 (more than 85 percent) were listed on either the New York Stock Exchange or NASDAQ — markets that are home to the largest corporations.

In short, the evidence indicates that since 1987 we have been in a period of significant corporate earnings restatements that have accelerated dramatically in the last five years; a rapidly growing percentage of the companies restating earnings are large, publicly traded companies.

37 Other companies that recently have restated previously inflated earnings include: AOL Time Warner ($190 million in 2000 and 2001, with a possible additional restatement of $400 million); Bristol-Myers Squibb ($2.5 billion from 1999 to 2002); Cendant Corp. ($500 million); Computer Associates ($1 billion); Enron ($1.2 billion in 2000); HealthSouth ($2.5 billion since 1986); Qwest Communications International ($144 million in 2000 and 2001); Rite Aid Corp. ($1.6 billion); and Xerox ($6.4 billion from 1997 to 2001). See Scandal Scorecard, supra note 9. Earnings manipulation has not been limited to U.S. corporations. Dutch food retailer Ahold NV has acknowledged that it exaggerated earnings by $1.08 billion from 2000 to 2002 (although Ahold’s U.S. subsidiary, U.S. Foodservice, accounted for $856 million of the overstatement). See Deborah Ball, “Ahold Chairman Plans to Resign Amid Overhaul,” The Wall Street Journal (Sept. 18, 2003), and “Ahold’s Estimate of Restatement Is Raised Again,” The Wall Street Journal (July 2, 2003). Likewise, in Italy, international dairy giant Parmalat SpA inflated its earnings by more than five times their actual amount. See Alessandra Galloni et al., “Scope of Scandal at Parmalat Widens to More Than $8 Billion,” The Wall Street Journal (Dec. 4, 2003).

38 COSO is a private-sector initiative, jointly sponsored and funded by the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, the Institute of Management Accountants, and the Institute of Internal Auditors.


40 Specifically, the study focused on violations of Rule 10(b)-5 of the 1934 Securities and Exchange Act and section 17(a) of the 1933 Securities Act. Id. at 4.

41 Id. at 5.


43 For purposes of the GAO study, an accounting irregularity was defined as an instance in which a company’s financial statements were not fairly presented in accordance with GAAP. Id. at 2.

44 Recognition of fictitious income would fall within the category of improper revenue recognition, while WorldCom’s improper capitalization of line costs would be classified as a cost- or expense-related issue. Id. at 20.

45 Id. at 4.

46 Id.

47 Id. at 4, n.6.
corporations; and in a substantial number of cases, those restatements correct for earnings inflated through fraudulent accounting activity. Although it is possible that corrective steps taken by the SEC and Congress to reduce fraudulent financial reporting may begin to reduce the incidence of earnings inflation, none of the available data suggest that it has yet occurred. Moreover, the COSO study makes it clear that although the number of cases has ballooned in the last few years, earnings inflation has been a persistent part of the corporate financial reporting picture for more than 15 years. It is likely that the concomitant tax fraud will persist for some time as well.

II. Current Rules Are Inadequate

A. Tax Fraud Penalties

All told, there are some 150 penalty provisions in the Internal Revenue Code. Of those, 5 are criminal penalties involving acts or omissions directed directly to the payment of income tax or reporting of income by taxpayers. They include penalties for evading tax, failing to collect or pay over tax, failing to file a return or supply information, signing or assisting in the preparation of a fraudulent or false income tax return, and delivering to the IRS a return known to be fraudulent or false. Only two of those provisions — sections 7206(1) and 7207 — apply to the type of fraud committed by WorldCom. Unfortunately, neither criminal penalty is likely to have any significant deterrent effect.

When a corporation like WorldCom files a federal income tax return reflecting fraudulently inflated income, it is subject to the felony “fraud and false statement” provisions of section 7206(1), or the misdemeanor “willful delivery or disclosure of false documents” provisions of section 7207. The principal difference between sections 7206(1) and 7207 is the conduct required for each. Section 7206(1) applies to any person who:

54The IRS Criminal Investigation Division also has jurisdiction to investigate violations of certain United States Code statutes. See 26 C.F.R. section 601.107(a) and http://www.irs.gov/compliance/enforcement/article/0,,id=108861,00.html (listing sections of the United States Code over which the Criminal Investigation Division has jurisdiction) (last visited December 30, 2004). Thus, a corporation also could be prosecuted under 18 U.S.C. section 1001, which applies to one who knowingly and willfully falsifies, conceals, or covers up by any trick, scheme, or device a material fact; makes any materially false, fictitious, or fraudulent statement or representation; or makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry. Because that provision is coextensive with section 7206(1), it is not discussed separately here.

55Under general agency principles, a corporation is considered to have committed any acts committed by agents or employees of the corporation acting within the scope of their employment. See New York Central and Hudson Railroad Company v. United States, 212 U.S. 481, 495 (1909) (“We see no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has intrusted authority to act.”). That includes acts related to the filing of corporate tax returns. See United States v. Shortl Accountancy Corp., 785 F.2d 1448, 1454 (9th Cir. 1986) (“A corporation will be held liable under 26 U.S.C.S. section 7206(1) when its agent deliberately causes it to make and subscribe to a false income tax return.”); Inner-City Temporaries, Inc. v. Commissioner of Internal Revenue, 60 T.C.M. (CCH) 726 (1990) (for a corporation, requisite fraudulent intent of section 6653 must be found in the acts of its officers and shareholders). For the corporation to be liable, the employee first must have intended that his act would have produced some benefit to the corporation or some benefit to himself and to the corporation second. See United States v. Gold, 743 F.2d 800, 823 (11th Cir. 1984). The reason for requiring that an agent have acted with intent to benefit the corporation is to prevent the corporation from being criminally liable for actions of its agents that are contrary to the company’s interests or solely for the agent’s benefit. See United States v. Automated Medical Laboratories, Inc., 770 F.2d 399, 407 (4th Cir. 1985). A corporation is not relieved of criminal liability, however, merely because the employee may have derived some personal benefit from his actions. See United States v. Ruidoso Racing Association, Inc. v. Commissioner, 476 F.2d 502 (10th Cir. 1973); The Crescent Manufacturing Company v. Commissioner, 7 T.C.M. (CCH) 630 (1948). Moreover, a corporation generally may not avoid criminal liability by simply asserting that an agent violated a corporate policy of adhering to the law. See Continental Baking Company v. United States, 281 F.2d 137, 150 (6th Cir. 1960) (“A corporation which employs an agent in a responsible position cannot say that the man was only ‘authorized’ to act legally and the corporation will not answer for his violations of law which inure to the corporation’s benefit.”); United States v. Hilton Hotel Corp., 467 F.2d 1000 (9th Cir. 1972), cert. denied 409 U.S. 1125 (1973) (“[Corporate] liability may attach without proof that the conduct was within the agent’s actual authority, and even though it may have been contrary to express instructions.”).
Willfully 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.

Thus, the first three elements necessary for conviction under that section are: an officer who willfully signs the corporation's tax return,66 the execution of that signature under penalty of perjury; and the officer's knowledge that the return is false and inaccurate. "Willfulness" refers to a voluntary, intentional violation of a known legal duty.57 As to the execution of the signature, a corporation's tax return always is signed under penalty of perjury.58 The "knowledge" element of the offense is satisfied in the context of a corporate defendant if the requisite knowledge is possessed collectively by the corporation's employees.59

Section 7207 applies to

Any person who willfully delivers or discloses to the Secretary any list, return, account, statement, or other document, known by him to be fraudulent or to be false as to any material matter . . .

Thus, the first two elements necessary for a conviction under that section are: a willful act of delivery or disclosure; and knowledge that the document delivered is false and inaccurate. As in the case of section 7206(1), willfulness means a voluntary, intentional violation of a known legal duty;60 and knowledge for these purposes may be imputed to the corporation on the basis of the collective knowledge of its employees.

The most critical element in these statutes, however, touches on the principal objection to the imposition of penalties on corporations that inflate their tax liability: What harm, if any, has the government suffered?

B. The Materiality Element: No Harm, No Foul?

It is important to observe that a tax deficiency is not a requisite element of either sections 7206(1)61 or 7207.62 However, each statute provides that the tax return giving rise to a conviction must be false and inaccurate "with respect to a material matter."63 How the courts have interpreted that element of the offenses is critical to the issue of whether a corporation overstating its taxable income and, therefore, paying too much tax should be penalized for doing so. Although an overstatement of income is technically fraudulent, is the deception really "material" if the consequence is a voluntary contribution to the public fisc? The courts have clearly answered that question in the affirmative. For example, in United States v. Rayar,64 the court held that an overpayment of tax would not exculpate the defendant from liability under section 7206(1) because the government "had a right to believe, before acting on the return, that the return reflected truthfully the income and expenditures."

The Supreme Court's pronouncement on the issue can be found in Badaracco v. Commissioner,65 a case in which the taxpayer filed a fraudulent return but later voluntarily disclosed the fraud in an amended return and paid the tax owed. When he subsequently was assessed a penalty for filing the original fraudulent return, the taxpayer asserted that as a matter of equity and public policy, the statute of limitations should bar imposition of the penalty. He argued that the amended return provided the government all of the information it needed to correctly assess the tax owed and that the tax owed had in fact been paid.66 In other words, no harm, no foul. The Court rejected the taxpayer's argument on the grounds that imposition of the fraud penalty was supported by "substantial policy considerations" even when no tax revenue was forfeited by the Treasury.67


59 The First Circuit has described it this way: "Corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. The aggregate of those components constitutes the corporation’s knowledge of a particular operation. " United States v. Bank of New England, N.A., 821 F.2d 844, 856 (1st Cir. 1987). See also United States v. Shortt Accountancy Corp., 785 F.2d 1448, 1454 (9th Cir. 1986). Were it otherwise, a corporation could avoid liability by simply asserting that no single employee comprehended the full import of information that was obtained by several employees. See United States v. Bank of New England, N.A., 821 F.2d 844, 856 (1st Cir. 1987).


61 See, e.g., United States v. Marabelles, 724 F.2d 1374, 1380 (9th Cir. 1984); United States v. Brooksby, 668 F.2d 1102, 1103-04 (9th Cir. 1982); United States v. Miller, 491 F.2d 638, 646 (5th Cir. 1974); reh’g denied 493 F.2d 664 (1974); United States v. Marashi, 913 F.2d 724, 736 (9th Cir. 1990); United States v. Jacobson, 547 F.2d 21, 24 (2d Cir. 1976).


64 204 F. Supp. 486, 490 (S.D. Cal. 1962), reh’g denied 323 F.2d 519 (9th Cir. 1963).


66 Id. at 397-398.

67 Id. at 398.
First, the court noted that fraud cases are more difficult to investigate because of the possibility that the taxpayer’s underlying records may have been falsified or even destroyed. As the court stated, “The filing of an amended return, then, may not diminish the amount of effort required to verify the correct tax liability. Even though the amended return proves to be an honest one, its filing does not necessarily remove the Commissioner from the disadvantageous position in which he was originally placed.”

Second, even if the amended return ultimately proves to be accurate, the court observed that the return “comes carrying no special or significant imprimatur; instead, it comes from a taxpayer who already has made false statements under penalty of perjury” and is therefore inherently less trustworthy.

Finally, although the amended return might reflect a prior underpayment of tax, it does not constitute an admission of fraud. Thus, the commissioner must still satisfy the burden of proof he bears on this issue with other evidence gleaned through careful investigation.

In short, imposition of the fraud penalty is justified by the administrative burdens imposed on the IRS by the filing of a fraudulent return, even in the absence of a tax deficiency.

**United States v. Goldman** identifies two additional policy considerations that support imposition of the fraud penalty for an overstatement of income. In that case, the taxpayer claimed that the false statements he made on his income tax return overstated his income and were therefore not material for purposes of section 7206(1). In holding that an overstatement of income was material for that purpose, the court noted that “[t]he accuracy of items of taxable income reported on the return of one individual or entity may affect the ability of the IRS to assess the tax liability of another taxpayer.”

The court also observed that “overstated income may shield from scrutiny falsely inflated deductions.”

Each of those consequences of tax fraud potentially impairs the ability of the IRS to determine if the correct amount of tax has been paid. Thus, the rule that has emerged from these and other reported decisions in this area is that a false statement in a tax return is material for purposes of prosecution under section 7206(1), if it is necessary to compute the tax involved, or has the potential for hindering the IRS’s efforts to monitor and verify the tax liability of the corporation and the taxpayer. The same rule applies to section 7207. Even a failure to properly characterize the source of income may be material for those purposes. Moreover, it is irrelevant whether the IRS actually makes use of the falsified information. As one court has observed, “One of the more basic tenets running through all the cases is that the purpose behind [section 7206(1)] is to prosecute those who intentionally falsify their tax returns regardless of the precise ultimate effect that such falsification may have.” That conclusion is reinforced by the fact that Congress made tax fraud under section 7206(1) a crime separate and apart from tax evasion under section 7201.

Unfortunately, vigorous IRS prosecution of publicly traded corporations for filing income tax returns reflecting artificial income in violation of those rules likely would have no discernible deterrent effect because of the nominal penalties that apply. For example, the fine imposed on a corporation that violates section 7206(1) is $500,000. A corporation violating section 7207 is subject to a penalty of $500,000.

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68 Id. (internal quotations omitted).
69 Id.
70 Id.
72 Id., at 344.
73 Id.
74 Id.
75 Id.
76 United States v. Warden, 545 F.2d 32 (7th Cir. 1976) (omitted items may be material when reporting is necessary “in order that the taxpayer estimate and compute his tax correctly.”); and United States v. Rayor, 204 F. Supp. 486, 490 (S.D. Cal. 1962), rev’d denied 323 F.2d 519 (9th Cir. 1963).
77 United States v. Peters, 153 F.3d 445, 461, Doc. No. 1997, 88 TNT 162-9 (7th Cir. 1998) (quoting United States v. Greenberg, 735 F.2d 29, 31 (2d Cir. 1984)). See also United States v. Goldman, 439 F. Supp. 337, 344 (S.D.N.Y. 1977) (“a statement is material if it is capable of influencing actions of the IRS in any matter within its jurisdiction.”); United States v. DiVarco, 343 F. Supp. 101, 103 (N.D. Ill. 1972), aff’d 484 F.2d 670 (7th Cir. 1973) (“Without truthful representation as to all matters it becomes administratively more difficult, if not impossible, for the Internal Revenue Service (IRS) to compute the amount of tax due or to check on the accuracy of returns.”); United States v. Greenberg, 735 F.2d 29, 31 (2d Cir. 1984) (“The purpose of section 7206 is not simply to ensure that the taxpayer pay the proper amount of taxes — though that is surely one of its goals. Rather, that section is intended to ensure also that the taxpayer not make misstatements that could hinder the Internal Revenue Service in carrying out such functions as the verification of the accuracy of that return or a related tax return.”); United States v. Taylor, 574 F.2d 232, 235 (5th Cir. 1978).
78 United States v. Fern, 696 F.2d 1269, 1274 (11th Cir. 1983).
79 United States v. DiVarco, 484 F.2d 670, 673 (7th Cir. 1973) (“The plain language of the statute does not exclude the matter of the source of income from the definition of ‘material matter.’ In light of the need for accurate information concerning the source of income so that the Internal Revenue Service can police and verify the reporting of individuals and corporations, a misstatement as to the source of income is a material matter.”).
81 United States v. Romanow, 509 F.2d 26 (1st Cir. 1975) (the primary purpose of section 7206(1) is to impose penalties of perjury on those who willfully falsify their returns, and the perjury occurs when the false entry is made, even if it is never relied on).
82 United States v. DiVarco, 343 F. Supp. 101, 103 (N.D. Ill. 1972), aff’d 484 F.2d 670, 673 (7th Cir. 1973). See also United States v. Scholl, 166 F.3d 964, 980, Doc. No. 9999-6310, 1989 TNT 34-11 (9th Cir. 1999) (“Whether there is an actual tax deficiency is irrelevant because the statute is a perjury statute.”); United States v. Holland, 880 F.2d 1091, 1096 (9th Cir. 1989) (“Any failure to report income is material.”).
83 See discussion of relationship between sections 7201 and 7206(1) supra note 20.
84 Although section 7206(5)(B) provides a penalty of $500,000, the Criminal Fine Enforcement Act of 1984, Pub. L. 98-596 (Footnote continued on next page.)
to a maximum fine of $200,000. 84 Those amounts are a pitance compared to, for example, the $300 million that WorldCom reportedly now has collected in tax refunds. What is needed is a robust penalty to deter corporations from making fraudulent statements to the IRS to bolster false earnings claims made to investors.

C. Getting a Tax Refund

At least part of what makes a corporation willing to pay additional tax to mask earnings fraud is the knowledge that any such tax paid may be recovered by means of a refund claim if the earnings fraud is discovered. Eliminating the tax refund in those situations would go far toward deterring the use of the tax system in this manner. Before discussing how refund claims might be denied in these circumstances, however, it may be helpful to review the refund process itself. As will be seen, the process is somewhat mechanical, and the IRS’s role in the process to date generally has been ministerial in nature.

The Treasury secretary is authorized to make refunds only of “overpayments” of tax. 85 Although the term is nowhere defined in the Internal Revenue Code, the Supreme Court has held that an overpayment arises from “the payment of more than is rightfully due.” 86 Thus, a company that has paid federal income tax on earnings that were fraudulently inflated quite clearly has made an overpayment for these purposes.

The Treasury secretary’s obligations regarding the refund (or crediting) of overpayments is governed by section 6402. 87 That section provides that when a person makes an overpayment, the secretary “shall . . . refund any balance to such person.” 88 The refund requirement, as applicable to corporations, is subject to only a few exceptions, discussed below. 89

First, the secretary may credit the amount of the overpayment against any outstanding internal revenue tax liability of the corporation making the overpayment. 90 Next, the amount of any overpayment to be refunded must be reduced by the amount of any past-due, legally enforceable debts owed to federal agencies. 91 Finally, if the corporation owes past-due, legally enforceable, state income tax obligations, the refund is further reduced by those amounts. 92 Apart from those exceptions, nothing in the statute authorizes the secretary to depart from the command of section 6402 that an overpayment of tax shall be refunded to the taxpayer. 93

Despite the existence of an overpayment and the secretary’s awareness of that overpayment, no refund will be forthcoming unless and until the taxpayer files a claim for refund. 94 A refund claim may be filed in one of two ways. First, if a corporation files a properly executed

84 See supra note 82, discussing application of maximum fines and regarding the U.S. Sentencing Guidelines.
85 Section 6402(a).
86 Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947) (An overpayment “may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment.” (Emphasis added.))
original income tax return reflecting an overpayment of tax for the tax year (for example, because of excess quarterly estimated tax payments), the return serves as the claim for credit or refund of that overpayment. Alternatively, if the overpayment is not discovered until after a tax return has been filed, the corporation must file an amended return on Form 1120X. In a situation involving inflated earnings, the corporate taxpayer knowingly files a false tax return reflecting excessive income and thus reports an income tax liability that is greater than what is rightfully due. The overpayment of tax generally is not “discovered” until the SEC uncovers the fraudulent inflation of earnings. Consequently, claims for refunds of tax paid on inflated earnings generally are filed by means of amended returns.

Once the amended return has been duly filed by the corporation, the IRS has six months to review the refund claim and determine whether to allow it. On the earlier to occur of the IRS’s disallowance of the refund claim and the expiration of six months from the date the refund claim is filed, the corporation may file a refund suit. The suit may only be brought in an appropriate federal district court or in the U.S. Court of Federal Claims. In summary, the federal income tax refund process is fairly straightforward. Refunds of overpayments of tax are statutorily required, and once the procedural prerequisites have been satisfied and a refund claim filed, the IRS has but to determine whether the tax paid is more than the amount rightfully due. If so, the refund apparently must be allowed, with accrued interest on the overpayment. The set of provisions leading to that result seems impervious to considerations of equity. However, it is precisely at the intersection of strict legal rules and apparent injustice that courts historically have exercised their equitable powers. That is, the role of equity within the legal system is to dispense justice at the interstices of inflexible legal rules. That is so even in matters pertaining to tax law.

III. Tax Refund Claims and Equity

As noted above, denying a refund is one way of dealing with a corporation that seeks a refund of tax paid on inflated corporate earnings. Because the corporation has deliberately violated the tax rules to mask its deceit, denying the refund would be “equitable” in the sense of responding to general concerns of fairness and justice.

However, equity refers to more than notions of morality and fair play. Equity has a well-defined formal dimension as well. The following section discusses why tax refund suits are subject to this formal aspect of equity.

A. Equity and the Tax Refund Suit

The Supreme Court made its clearest pronouncement regarding the equitable nature of the tax refund suit in *Stone v. White*. In that case, a testator left property in trust for his wife, who elected to receive the income from the trust in lieu of any dower or statutory interest. At the time, several circuit courts of appeals had held that the relinquishment of dower rights in favor of trust income constituted payment for a deemed annuity. Accordingly, income from the trust was not taxable to the beneficiary until the aggregate income payments received exceeded the amount deemed paid for the annuity.

In conformity to those decisions, the wife of the testator in *Stone* did not report the income she received from the trust. Rather, the tax on the income was assessed against and paid by the trust. After the statute of limitations had run for collecting the tax from the testator’s wife, the Supreme Court, in *Helvering v. Butterworth*, overruled the earlier circuit court decisions and concluded that beneficiaries indeed were taxable on trust income.

B. The Exercised Powers of Equity

The equitable powers regarding the resolution of tax refund suits properly belong to the latter governs the circumstances under which a plaintiff may pursue an equitable remedy. Accordingly, income from the trust was not taxable to the beneficiary until the aggregate income payments received exceeded the amount deemed paid for the annuity.

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For example, because of excess quarterly estimated tax payments, the return serves as the claim for credit or refund of that overpayment. Alternatively, if the overpayment is not discovered until after a tax return has been filed, the corporation must file an amended return on Form 1120X. In a situation involving inflated earnings, the corporate taxpayer knowingly files a false tax return reflecting excessive income and thus reports an income tax liability that is greater than what is rightfully due. The overpayment of tax generally is not “discovered” until the SEC uncovers the fraudulent inflation of earnings. Consequently, claims for refunds of tax paid on inflated earnings generally are filed by means of amended returns.

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income. In response to the Butterworth holding, the trustees in Stone sued to recover the tax they had paid on the trust’s income. In a rather extraordinary decision, the Supreme Court denied the trust’s refund claim. The Court disregarded the fact that the trust and beneficiary were distinct legal entities and treated the tax obligation of the beneficiary as the tax obligation of the trust. The Court reasoned that if the tax paid by the trust were refunded, it would inure to the benefit of the trust beneficiary, who already had escaped taxation on the trust income by virtue of the expiration of the statute of limitations.208

The Court grounded its authority to ignore the legal forms and “do equity” in this manner in the historically equitable nature of the tax refund suit.109 The Court stated that a tax refund suit “brought to recover a tax erroneously paid, although an action at law, is equitable in its function,” thus establishing the equitable character of an action that admittedly could be traced to the common law.110 The Court noted that actions in indebitatus assumpsit had long been used to recover on rights of an equitable nature and that such suits were invariably controlled by equitable principles.111 The Court also observed that the statutes that authorized tax refund claims and suits were founded on the same equitable principles underlying the indebitatus assumpsit action.112 In short, tax refund suits, as direct descendants of the indebitatus assumpsit action, have a strong equity flavor, and courts hearing them have the authority to exercise broad equitable powers.

Because the tax refund action is equitable in nature, it may be defended in equity as well. As the Supreme Court observed in Stone v. White, “since, in a [tax refund] action, the plaintiff must recover by virtue of a right measured by equitable standards, it follows that it is open to the defendant to show any state of facts which, according to those standards, would deny the right.”113 In a case decided the same day as Stone v. White, the Supreme Court also held that through the tax refund suit, the commissioner can secure “a final adjudication of his right to withhold the overpayment . . . on the ground that other taxes are due from the taxpayer, or that upon other grounds he is not equitably entitled to the refund.”114 Thus, in a refund suit, the IRS has at its disposal the entire range of equitable defenses.

B. The Doctrine of Unclean Hands

One of the most familiar of the equitable maxims is that “one who comes into equity must come with clean hands.” The maxim is more than a “mere banality,” however;115 it is the underpinning of the doctrine of unclean hands, which the Supreme Court has described as “an ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief.”116 The doctrine is rooted in the historical concept of the court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith.117 Under the unclean hands doctrine, a court sitting in equity has wide-ranging discretion in refusing to aid the unclean litigant, and is “not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion.”118

1. In general. The essence of the doctrine of unclean hands is the denial of equitable relief to a plaintiff who commits a wrong in the same transaction in which he claims to have been injured. For example, in Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co.,119 the plaintiff sought to enforce a contract involving patents that it knew were fraudulent when the contract was executed. The Supreme Court declined to enforce the contract, holding that the plaintiff’s conduct in failing to disclose the patent fraud to the U.S. Patent Office did not “conform to minimum ethical standards and [did] not
justifying [plaintiff’s]... attempt to assert and enforce... perjury-tainted patents and contracts.”120

It is not necessary that the misconduct giving rise to application of the doctrine be punishable as a crime or otherwise be legally actionable.121 Any willful act transgressing even minimal ethical standards of conduct is sufficient cause for invocation of the doctrine, as indicated by the language quoted above from Precision Instrument.122 By the same token, the doctrine of unclean hands clearly applies when the plaintiff’s act consists of the direct violation of a statute.123 Of course, the statutory violation must be closely related to the matter being litigated. Courts will apply the doctrine only when the plaintiff’s act in some measure affects the equitable relations between the parties regarding the issue brought before the court for adjudication.124

An important consideration in the application of the doctrine of unclean hands is the resulting effect on public policy. When a suit in equity relates to the public interest, the doctrine of unclean hands assumes wider and more significant proportions, because application of the doctrine to deny relief not only resolves a private injustice, but also it has the potential to avert an injury to the public.125 For example, in Precision Instrument, the Supreme Court observed that the possession and assertion of patent rights were “issues of great moment to the public” and assessed the claims at issue against public, as well as private, standards of equity.126 The Court’s ultimate refusal to enforce the plaintiff’s patent claims therefore supported the public interest in seeing that patents, and the monopolies inherent in them, be limited to their proper scope and be granted in an environment free of fraudulent conduct.127

2. Application to tax refund claims. As just discussed, courts have denied equitable relief under the doctrine of unclean hands for conduct ranging from a breach of “minimum ethical standards”128 to direct violations of law, statutes, or regulations.129 Although the latter, “narrow” form of the conduct standard is satisfied by violation of a tax statute such as section 7206(1), the Supreme Court has held that breach of the “broad” form of the conduct standard is sufficient to constitute unclean hands.130 Because the broad form of the standard potentially could raise thorny questions as to the scope of “minimum ethical standards,” the framework proposed in this article would adopt the narrow form of the conduct standard. In other words, as an initial matter, a refund claim would be summarily denied only if the taxpayer had directly violated a statute connected with the matter in litigation.

In a case like WorldCom’s, the requisite elements of the doctrine of unclean hands are all present. WorldCom seeks equitable relief in the form of a refund of excess taxes paid. However, the company has committed a wrong in the very transaction in which it claims to have been injured, the paradigm case for application of the doctrine of unclean hands. WorldCom directly violated section 7206(1), and thus satisfies the narrow form of the conduct standard. There is no need to inquire as to whether WorldCom also breached standards of ethical conduct.

The tax statute that WorldCom violated is also closely related to the issue being litigated. Had WorldCom not filed false tax returns for the years in question, no excess tax would have been paid and there would be no need for a tax refund claim. Moreover, WorldCom used the false tax returns, payment of the tax, and, by extension, the imprimatur of the Treasury to lend legitimacy to its scheme to commit securities fraud. Thus, WorldCom’s fraud measurably “affects the equitable relations between the parties” regarding the tax refund claim.131

Denying WorldCom’s equitable claim for a tax refund in those circumstances also comports with the public policy aspect of the unclean hands doctrine. The calculation and verification of income tax liability by Treasury is no less important than the possession and assertion of patent rights that, in Precision Instrument, were held to be of “great moment to the public.”132 The courts have frequently noted the strong public policy interest in the accurate reporting of income.133 The U.S. tax system relies heavily on truthful self-reporting by taxpayers. If each

120Id., at 815.
121See New York Football Giants, 291 F.2d at 474 (”One’s misconduct need not necessarily have been of such a nature as to be punishable as a crime or as to justify legal proceedings of any character. Any willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for the invocation of the maxim.”).
122Precision Instrument, 324 U.S. at 815.
123See Metro Motors v. Nissan Motor Corp. in USA, 339 F.3d 746, 750-751 (8th Cir. 2003) (”Well-accepted general principles of equity support plaintiff’s contention that a statutory violation gives a party unclean hands.”); Smith v. World Ins. Co., 38 F.3d 1456, 1463 (8th Cir. 1994) (“Equity, under the general maxim that one who seeks equity must come with clean hands, will refuse its aid to a litigant who violates a statute directly connected with the matter in litigation.”).
128Id. at 815 (transgression of equitable standards of conduct); New York Football Giants, 291 F.2d at 474 (to same effect).
129See Metro Motors v. Nissan Motor Corp. in USA, 339 F.3d 746, 750-751 (8th Cir. 2003) (statutory violation); Smith v. World Ins. Co., 38 F.3d 1456, 1463 (8th Cir. 1994) (violation of a statute); In re Estate of Bruner, 338 F.3d 1172, 1177 (10th Cir. 2003) (unlawful or inequitable conduct; defrauding the government); Intercorp, Inc. v. Pennzoil Co., 1987 U.S. Dist. LEXIS 12041 (N.D. Ala. 1987) (illegal conduct); Promac, Inc. v. West, 203 F.3d 786, 789 (Fed. Cir. 2000) (violation of federal regulations).
130Precision Instrument, 324 U.S. at 816.
133See supra notes 66 to 80 and accompanying text.
potential taxpayer does not disclose honestly all information relevant to tax liability, the integrity of the entire tax system is undermined.\textsuperscript{134} To the extent that a tax system relies on records, accounts, and information that are fabricated, false, or fraudulent, it is to that extent a broken system. As the Seventh Circuit has observed, “For the... system to function properly, there must be not just truthful reporting, but also the ability to assure truthful reporting.”\textsuperscript{135} In other words, a false income tax return in the specific case is detrimental because its very presence creates legitimate doubt about the accuracy and truthfulness of all federal income tax returns within the system, both individual and corporate.

Public doubt about the reliability of federal income tax returns, in turn, tends to discourage the voluntary compliance on which the U.S. tax system relies.\textsuperscript{136} A perception by the public that corporate taxpayers flaunt the tax rules can only undermine the system. The Ninth Circuit enunciated that concern in United States v. Lowe.\textsuperscript{137} In affirming a conviction for filing false tax returns in violation of section 7206(1), the court stated:

The United States’ tax-assessment scheme relies on truthful self-reporting by taxpayers... The purpose of the Internal Revenue Code is to induce the prompt and forthright fulfillment of every duty under the income tax law. Because the tax system is based on self-reporting, the government depends upon the good faith and integrity of each potential taxpayer to disclose honestly all information relevant to tax liability. One of the duties of taxpayers is to provide the IRS with accurate information, including the actual amount of refund due. Any other result would undermine the self-reporting requirements of the entire tax system.\textsuperscript{138}

In short, if the system is perceived to be infected with fraud, voluntary compliance will be impaired.\textsuperscript{139}

Tax fraud also creates additional burdens for the IRS.\textsuperscript{140} Indeed, one element of the offense of filing a false tax return under section 7206 is that the false statement or the return is “material,” which, as discussed above, means the statement is necessary to compute the tax involved, or has the potential for hindering the IRS’s efforts to monitor and verify the tax liability of the corporation and the taxpayer.\textsuperscript{141} Thus, the language of the tax fraud statute as interpreted by the courts suggests its own partial justification for criminalizing tax fraud: It saddles the IRS with additional administrative responsibilities. Quite clearly then, the filing of a fraudulent income tax return can cause a very real detriment to the government in derogation of public policy. Because of equity’s concern with public policy, it seems particularly appropriate to apply the doctrine of unclean hands to determine whether a corporation in WorldCom’s circumstances is entitled to receive a tax refund.

One could construct a public policy argument that suggests it is unfair for the IRS to retain unowed taxes that otherwise might be used to mitigate damages suffered by innocent creditors and shareholders. There are two responses to that argument. First, shareholders assume the risks of their equity investments in a corporation, including risks related to the behavior of management. Sometimes the assumption of those risks is rewarded; sometimes corporate shareholders are penalized.\textsuperscript{142} Moreover, by way of trade-off, the corporate shareholder enjoys immunity from personal liability for the actions of corporate management when those actions injure third parties, including creditors.

Second, unowed taxes retained by the Treasury are in the nature of a penalty because they are retained as a result of the taxpayer’s fraudulent conduct. The imposition of a penalty is not considered inequitable even noncompliance with the tax system. As one measure of compliance, the study evaluated attitudes condoning tax cheating. An important variable that was closely linked to tax noncompliance by that measure was “skepticism about human integrity.” As defined by the study, that variable reflects the belief that most people cheat; indeed, that the only people who don’t cheat are those who can’t find opportunity to do so. When taxpayers were asked to assign weights to several reasons why “other people” cheat on taxes, one of the factors most responsible for cheating was the perception that the tax system is unfair. See Yankelovitch \textit{et al.}, Internal Revenue Service, Taxpayer Attitudes Study: Final Report (1984). There is substantial economic literature on the effect of taxpayer attitudes on tax compliance, with most researchers concluding that taxpayer perceptions of fairness in the tax system and perceptions of compliance by other taxpayers significantly affect the overall rate of tax compliance. See, \textit{e.g.}, Steven M. Sheffrin and Robert K. Triest, “Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance,” in \textit{Why People Pay Taxes} 193 (Joel Stimmrod ed., 1992).

134\textit{United States v. Bove}, 155 F.3d 44, 49, Doc 98-26364, 98 TNT 164-18 (2d Cir. 1998) (filing a false tax return in violation of section 7206(1) is an offense that undermines the “public interest in preserving the integrity of the nation’s tax system.”). See also \textit{United States Sentencing Commission, Guidelines Manual}, section 2T1.1 (November 2003), Introductory Commentary (“The criminal tax laws are designed to protect the public interest in preserving the integrity of the nation’s tax system.”).

135\textit{United States v. Paepke}, 550 F.2d 385, 391 (7th Cir. 1977) (emphasis added).

136\textit{Spies v. United States}, 317 U.S. 492, 495 (1943) (“The United States has relied for the collection of its income tax largely upon the taxpayer’s own disclosures rather than upon a system of withholding the tax from him by those from whom income may be received. This system can function successfully only if those within and near taxable income keep and render true accounts.”). Although the U.S. tax system relies much more heavily on withholding than it did in 1943, when \textit{Spies} was decided, there remain enough exceptions to withholding today to warrant concern about any trends in taxpayer behavior that would tend to undermine voluntary compliance.

1371996 U.S. App. LEXIS 1628 at *9 (9th Cir. 1996).

138\textit{Id.} (Emphasis added."

139Although now several years out of date, the IRS commissioned a study in 1984 to better understand what factors drove (Footnote continued in next column.)
though it denies the wrongdoer possession of funds to which he otherwise would be entitled. The denial of a refund of taxes by the IRS differs from an outright penalty only in that it is imposed by a court out of considerations of fairness and justice in the particular case, rather than as a matter of positive statutory law. As a matter of policy, penalties for corporate wrongdoing ought not to be waived simply because shareholders were not directly involved in the wrongdoing. Taken to its logical conclusion, that argument would preclude imposition of virtually all monetary penalties on corporations because shareholders rarely are involved in management activities, fraudulent or otherwise.

IV. Equitably Evaluating Tax Refund Claims

So far, this article has assessed the scope of the earnings inflation problem and its impact on tax reporting, examined the inadequacy of existing penalties to effectively discourage the tax fraud related to earnings inflation, and reviewed both the equitable pedigree of tax refund claims and the equitable doctrine of unclean hands that might be asserted in response to those claims. The remainder of the article proposes a simple framework for employing equity to address fraud-related tax refund claims. Both the IRS and the JCT would be involved in the process of assessing refund claims and determining whether the IRS should raise equitable defenses to the payment of those claims.

A. Establishing the Tax-Fraud Connection

Until recently, no mechanism existed for determining whether a particular refund claim would qualify as an equity case. That is, there was no simple way of linking a given tax refund claim to fraudulent activity on the part of the corporate taxpayer that might give rise to an equitable defense to the claim. In a case such as WorldCom’s, in which the accounting fraud was widely reported by the media, the IRS could, of course, ferret out the tax fraud that masked the earnings inflation. Not all cases, however, would necessarily be as publicly visible.

Fortunately, this knowledge gap will be eliminated for tax years ending on or after December 31, 2004. In an effort to increase the transparency of corporate tax return filings in general, Treasury and the IRS have issued Schedule M-3, which replaces the current Schedule M-1 on which a corporation reconciles the difference between its book income and taxable income.143 Importantly, the new Schedule M-3 asks the reporting corporation whether it has restated its financials for periods covered by the schedule and, if so, requests an explanation of such restatement.144 As a result, the IRS will be alerted to the presence of an earnings restatement, a significant step toward establishing a nexus between accounting fraud, on the one hand, and tax fraud, on the other.

A company filing a refund claim would have to decide how to respond to the questions on the new Schedule M-3. When, as in WorldCom’s case, the company’s accounting fraud is exposed through SEC enforcement action and widely recounted by the media, the earnings restatement would be a matter of public knowledge. The company would have little choice but to confirm the obvious. Of course, a less well-known company might attempt to falsify that information. Because refund claims involving inflated earnings generally are not filed until after the SEC has uncovered the earnings fraud and initiated enforcement action, however, it is highly unlikely that a company would engage in fraud again by falsifying information on the Schedule M-3 included as part of a refund claim and subjecting itself to additional tax fraud penalties.145 However, in most cases it would not be difficult for the IRS to determine the veracity of the company’s Schedule M-3. An Electronic Data Gathering, Analysis, and Retrieval System search would disclose any SEC filings that a publicly traded company made for the year the refund is claimed, and any restatement of earnings would (or at least should) be discussed in those filings.

During IRS processing, a Schedule M-3 that indicated that earnings were restated in the year for which the refund is claimed should immediately trigger closer scrutiny. If WorldCom, for example, had been required to reflect the fact that it had restated its earnings, the IRS quickly could have located the company’s financial statements and discovered the fraudulent inflation of income reflected on its tax return. In those circumstances, one would expect that the IRS automatically would seek to impose liability under section 7206(1). Filing a false or fraudulent return in contravention of that provision would reflect the fact that it had restated the earnings fraud and initiated enforcement action, however, it is highly unlikely that a company would engage in fraud again by falsifying information on the Schedule M-3 included as part of a refund claim and subjecting itself to additional tax fraud penalties.145 However, in most cases it would not be difficult for the IRS to determine the veracity of the company’s Schedule M-3. An Electronic Data Gathering, Analysis, and Retrieval System search would disclose any SEC filings that a publicly traded company made for the year the refund is claimed, and any restatement of earnings would (or at least should) be discussed in those filings.

Regardless of whether a penalty under section 7206(1) is imposed, the IRS should investigate the relationship between the earnings inflation and the refund claim and include a discussion of the matter in any report submitted to the JCT, as discussed below. In short, the issuance of Schedule M-3 now provides information which the IRS may proceed to investigate further. The fruits of that


145Falsifying information on Form 1120X and accompanying schedules such as Schedule M-3 would subject the company to the penalty provisions of sections 7206(1) and 7207.

146The doctrine of unclean hands requires bad conduct on the part of the taxpayer. Although that conduct need not rise to the level of a statutory violation, such a violation clearly establishes that the taxpayer has unclean hands. See supra notes 118 to 123 and accompanying text.
investigation should be submitted for equitable review to the JCT in the manner described in the following section.

**B. Expanding JCT Review**

A policy of denying certain tax refund claims on equity grounds should reflect the limits of IRS resources by targeting only sizable tax refund claims. One approach to the refund selectivity issue would be to link equitable review of tax refund claims to the existing JCT refund review process.

The JCT comprises five members of the Senate Finance Committee and five members of the House Ways and Means Committee (in each case, three of whom are members of the majority party and two of whom are members of the minority party). The JCT staff is responsible for several activities, including assisting members of Congress in preparing bills for introduction, facilitating Ways and Means Committee and Finance Committee markups of tax legislation, and drafting the explanation of legislation contained in the reports of the Ways and Means, Finance, and conference committees.

One of the principal tasks assigned by Congress to the JCT is to review some tax refunds and credits. Under current law, a refund in excess of $2 million may not be paid until after the expiration of 30 days from the date on which a report summarizing the proposed refund is submitted for review to the JCT. The report must specify the name of the person (or entity) to whom the refund or credit is to be made, the amount of the refund or credit, and a summary of the relevant facts. The report mandated by section 6405 is prepared by personnel within the IRS and submitted to the JCT. The report is then reviewed by staff attorneys working under the supervision of the JCT’s chief of staff. If no problems appear on the face of the report, the JCT notifies the IRS that it has no objection to payment of the refund.

When presented with a report from the IRS regarding a refund claim in excess of $2 million that arises in connection with earnings inflation activity by the taxpayer, the JCT should evaluate the applicability of the various equitable defenses based on the conduct of the taxpayer and advise the IRS in appropriate cases to deny the refund claim on those grounds. Importing equitable considerations into the rather perfunctory JCT review would add significance to the work of the JCT staff in this area. Moreover, the existing JCT review process would provide an efficient structure within which to apply the equitable principles described in this article to fraudulent tax refund claims.

**Conclusion**

The available evidence suggests that the recent earnings inflation scandals involving large, publicly traded corporations represent a rising tide of inflated earnings reports produced by a significant number of U.S. corporations over the last two decades. The tide does not appear to be ebbing, but even if it were to do so, it is likely that a significant number of cases of earnings inflation will persist. Earnings inflation is often disguised by a corresponding tax fraud — the inflation of taxable income. Like all tax fraud, this particular variety threatens the integrity of the federal income tax system, but it is particularly troublesome because existing penalties provide an inadequate deterrent. However, the IRS is not without the means to combat such activity. Because of the equitable nature of tax refund suits, refund claims may be denied when they are associated with fraudulent earnings inflation that would give rise to the traditional equitable defense of unclean hands.

The IRS should move quickly to identify earnings-inflation-related tax refund claims by carefully scrutinizing Schedule M-3, including in its tax refund reports to the JCT a summary of any fraudulent activity engaged in by the taxpayer, and, when appropriate, recommending assertion of the defense of unclean hands to the refund claim. For its part, the JCT should evaluate large refund claims in light of equitable principles and in appropriate circumstances deny those claims.

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147Section 8002.


149Section 6405(a). Note that this provision does not specifically grant the JCT veto power over the payment of large refunds; it merely requires a 30-day delay period. As a practical matter, however, the IRS will not generally issue those refunds without JCT approval. See Diana Lisa Erbsen, “The Joint Tax Committee Refund Review Function: Is It ‘Worth a Damn’?” Tax Notes, July 8, 1996, p. 227.

150Section 6405(a). The statute also requires that the report include the “decision of the Secretary,” but that seems superfluous, because there would be no refund to trigger the reporting requirement unless the Secretary had determined to pay the refund claim.

151See Erbsen, supra note 149.