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Investors Who Relied on Tax Opinions May Not Recover Back Taxes and Interest Paid for Disallowed Deductions

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ability and fitness for a particular purpose and for breach of an express warranty. Under the Connecticut Uniform Commercial Code ("UCC"), a party may only recover breach of warranty damages against a seller or a merchant. Conn. Gen. Stat. §§ 42a-2-313 - 2-315 (1985). The Connecticut UCC defined a seller as a "person who sells or contracts to sell goods." Conn. Gen. Stat. §§ 42a-2-103(1)(d) (1985). The court previously held that GM was not in the business of selling Dexron II. Thus, the court concluded that Petrol Plus could not recover under the UCC warranty provisions, since GM, by definition, was not a "seller."

Petrol Plus also argued it should receive indemnification based on the common law theory of warranty. However, the court determined that a party would have to establish significant involvement in the stream of commerce to recover under this theory. The court found that Petrol Plus did not prove this threshold participation by GM. The court thus rejected Petrol Plus's indemnification claim based on a common law warranty theory.

Connecticut Unfair Trade Practices Act

CUTPA, Conn. Gen. Stat. § 42-110b(a) (1985), provides that "no person shall engage in unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce." In its definition of trade or commerce, the statute includes advertising, selling, and distributing goods. Once again, the court held that GM did not fit the statutory definition. GM did not advertise the Dexron II transmission fluid nor did it sell or distribute the defective transmission fluid. Thus, the Connecticut Supreme Court affirmed the trial court's refusal to charge the jury with respect to Petrol Plus's CUTPA claim.

Suzanne Kuzmenka

Investors Who Relied On Tax Opinions May Not Recover Back Taxes And Interest Paid For Disallowed Deductions

In *Alpert v. Shea Gould Climenko & Casey*, 559 N.Y.S.2d 312 (1990), the Supreme Court of New York, Appellate Division denied recovery to investors of back taxes and interest which they were required to pay to the Internal Revenue Service after the deductions they took were disallowed. The investors had relied on the opinions of two law firms and invested in a coal mining tax shelter. In addition, the court held that the investors could not amend their complaints to assert additional claims for fraud and breach of fiduciary duty.

Background

On December 16, 1977, the United States Treasury Department ("Treasury") amended one of its regulations to disallow deductions from gross income for advance minimum royalty payments in connection with mineral properties. Treas. Reg. § 1.612-3(b)(3) (1977). An advance minimum royalty is a fixed amount of money to be paid to the owner of mineral property before mining begins, as opposed to periodic royalty payments made in proportion to the amount of minerals mined. Three days later, the Internal Revenue Service ("I.R.S.") revised a revenue ruling to provide that taxpayers may not take an immediate deduction for the full amount of the advance minimum royalty payment but must take deductions for such payments only in the year in which the corresponding minerals are extracted. Rev. Rul. 77-489, 1977 I.R.B. 51.

Prior to these Treasury and I.R.S. releases, Esanu, Katsky and Korins (the "Esanu firm"), a law firm, had structured Logan Properties Program ("Logan"), a coal mining business. Logan appeared to provide investors an opportunity for immediate deduction of an advance minimum royalty to be paid by Logan. By December 21, 1977, following publication of the government releases, the Esanu firm withdrew its opinion with respect to the Logan investment program. The Esanu firm advised the operating manager of Logan that while there was a basis in law for taxpayers to deduct Logan's advance minimum royalty payment, there was also a significant chance that the I.R.S. would disallow such a deduction in part or in full.

Logan then asked Shea Gould Climenko and Casey ("Shea Gould") for an opinion letter to be included in its promotion materials. On December 20, 1977, Shea Gould opined that there was a reasonable basis for concluding that the revenue ruling was invalid. However, Shea Gould advised that taxpayers who invested in Logan might, nevertheless, would be unable to deduct the advance minimum royalty payment immediately upon investing in Logan if the I.R.S. successfully applied the distortion of income concept.

On December 30, 1977, George Alpert ("Alpert") and Lee Wolfman ("Wolfman") each invested $52,500 in Logan. Alpert and Wolfman based these investment decisions on the tax opinions of the Esanu firm and Shea Gould. On their 1977 tax returns, Alpert and Wolfman each deducted $ 216,645 for advance minimum royalty payments for the right to mine coal. On their 1978 returns, each deducted $10,893 for the advance minimum royalty payments. In 1984 and 1985, the I.R.S. disallowed the deductions taken by Alpert and Wolfman in 1977 and 1978. Alpert and Wolfman had to pay the tax deficiencies plus interest.

In 1984, Alpert and Wolfman each commenced actions against the advising law firms for fraudulent misrepresentation. In the lawsuits, Alpert and Wolfman sought lost profits and recovery of the tax benefits they would have received if they had not relied on the opinions of the Esanu firm and Shea Gould and had instead invested in a viable tax shelter. Alpert and Wolfman

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also sought the interest they were required to pay on the back taxes. The two actions were combined for consideration by the Supreme Court, New York County.

Supreme Court, New York County

The lower court dismissed the claims of Alpert and Wolfman for back taxes but allowed recovery of the interest paid on the deficient taxes. Further, the court allowed the investors to amend their complaints to assert an additional claim of breach of fiduciary duty but denied them leave to amend their complaints to include an additional cause of action in fraud.

Supreme Court, Appellate Division

On appeal, the court first rejected the damage claims of Alpert and Wolfman for back taxes. The court stated that the recovery of damages for fraud is limited to that which is necessary to restore a party to the position occupied before commission of the fraud. The court noted that the victim of fraud may not recover the benefit of an alternative agreement overlooked in favor of the fraudulent one. Therefore, the court denied Alpert and Wolfson recovery of back taxes in this case because such recovery would place the investors in a far better position than had they never invested in Logan.

Additionally, the court denied Alpert and Wolfman leave to amend their complaints to assert an additional cause of action in fraud against the Esanu firm which had structured Logan. The original complaint alleged only that the Esanu firm's opinion was knowingly false, while the proposed amended complaint alleged that the facts in the Logan offering memorandum were false. The court denied leave to amend because the original complaint did not give the proper notice necessary to enable the Esanu firm to prepare a defense since the complaint did not sufficiently state the circumstances surrounding the amended fraud claim. In addition, such an amendment would require supplemental discovery that would result in prejudicial delay of the case. Therefore, the court denied leave to amend to include a second cause of action in fraud.

As to the issue of recovery of interest paid on the deficient taxes, the court held that recovery of interest must be denied. The court cited a case in which the United States Court of Appeals for the Second Circuit found that a defrauded investor in a coal mine tax shelter was not allowed to recover interest paid to the I.R.S. upon disallowance of tax deductions. That court reasoned that such interest did not constitute damages suffered by the investor but rather was a payment to the I.R.S. for the investor's use of the money during the period when he was not entitled to it. The New York court adopted the reasoning of the Second Circuit. The court also reasoned that it was more equitable to bar recovery of interest rather than to allow the investors the windfall of both having used the tax monies for seven years and recovering all interest thereon.

Lastly, the court denied leave to amend the complaints to include assertions of breach of fiduciary duty because there was no support for the conclusion that such a fiduciary relationship existed between Alpert and Wolfman and the Esanu firm and Shea Gould in the absence of a contractual relationship between the parties. The court used a three-prong test to determine whether professionals, such as the defendant law firms, would be liable for negligence for inaccurate reports. Under the test, (1) the professional must have been aware that the reports were to be used for a particular purpose, (2) there must have been a known party who intended to rely on the reports for furtherance of a purpose, and (3) there must have been some conduct on the part of the professional evidencing his knowledge of the other party's reliance on the report.

In this case, the court held that Alpert and Wolfman failed to satisfy the test because there was no evidence that the Esanu firm and Shea Gould were aware that the potential investors would rely on their tax opinion letters or that Alpert and Wolfson, in particular would. The class of potential investors was neither fixed nor identifiable.

Astrid E. Ellis

Imposing Penal Sanctions For Breach Of Home Improvement Contract, In The Absence of Fraud, Is Involuntary Servitude

In ***State v. Brownson***, 459 N.W.2d 877 (Wis. App. 1990), the Court of Appeals of Wisconsin held that the state, absent some indicia of fraud or misrepresentation, may not impose penal sanctions for breach of a labor contract. The court held that doing so constitutes the type of involuntary servitude prohibited by the United States and Wisconsin Constitutions. The court also held that challenges to a statute based upon the "overbreadth doctrine" must be linked to a first amendment claim, and that the state, in criminal proceedings, need not prove intent unless it is a statutorily required element of the crime alleged.

Background

James Brown ("Brown") asked William Brownson ("Brownson") to build a garage. Brownson was the general manager of Professional Workers Construction ("PWC"). In a written home improvement contract, the two men agreed that Brownson, through PWC, would build the garage for $5,525.00. Brown made a down payment of twenty percent of the garage's total cost and additional payments of $3,315.00 and $826.80. Brownson never completed the garage. One unpaid materialman filed notice of intent to file a lien.

In May 1990, the Circuit Court of Outagamie County, Wisconsin convicted Brownson of violating three provisions of the Wisconsin Administrative Code: (1) § Ag 110.05(2)(d), failure to include the