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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 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.


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

Suzanne Kuzmenka
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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.

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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