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Tax estoppel: Litigation positions inconsistent with tax returns

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In their Commercial Division update, Thomas Hall and Judith Archer discuss how recent decisions have routinely applied tax estoppel where appropriate, but also have highlighted limitations to the application of the doctrine. They examine a number of rulings that reflect the clear application of tax estoppel, and its use both offensively or defensively.

The fundamental principle behind all types of legal estoppel is that there are some positionsthat a party should be prevented from taking based on some past action, assertion or matter that has already been fixed. Collateral estoppel, for example, prevents a party from relitigating an issue decided in a prior action. See *Continental Cas. Co. v. Rapid American*, 80 N.Y.2d 640, 649 (1993). Promissory estoppel prevents parties from avoiding commitments made when those promises would otherwise not be considered to be binding contracts. *See Matter of Hennel*, 29 N.Y.3d 487 (2017). Judicial estoppel prevents a party from asserting a position in a legal proceeding that is contrary to a position previously successfully taken by the same party in a prior legal proceeding. See *Herman v. 36 Gramercy Park Realty Assoc.*, 165 A.D.3d 405 (1st Dept. 2018).

Closely related to judicial estoppel is the doctrine of tax estoppel, which prevents a party from taking factual positions in legal proceedings in contradiction of disclosures in tax returns. As discussed below, recent Commercial Division decisions have routinely applied tax estoppel where appropriate, but also have highlighted limitations to the application of the doctrine.

General standard

The New York Court of Appeals formally embraced the doctrine of tax estoppel in *Mahoney-Buntzman v. Buntzman*, 12 N.Y.3d 415, 422 (2009), a divorce case in which the husband had previously stated in a federal tax return that $1.8 million received pursuant to a stock buyout agreement was business income, not investment income, which reduced the taxes owed on that income.

In this divorce action, however, he argued that the same $1.8 million was instead investment income, and not business income, which if true would have protected it from being treated as marital property and equitably divided. The court affirmed the trial court's rejection of thisargument that

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contradicted the tax return, stating: "We cannot, as a matter of policy, permit parties to assert positions in legal proceedings that are contrary to declarations made under the penalty of perjury on income tax returns."

The policy rationale behind tax estoppel is straightforward. Tax returns require filers to declare, under the penalties of perjury, that they have examined the return, including any accompanying reports, schedules or statements, and that to the best of their knowledge and belief the return is true, correct and complete. "This unambiguous declaration in the IRS form is the foundation of the doctrine of tax estoppel." *Gliklad v. Kessler*, 2016 NY Slip Op 31301[U],*8 (N.Y. Co. 2016).

Commercial Division application

A number of recent Commercial Division decisions reflect the clear application of tax estoppel, and its use both off ensively or defensively.

In *Gliklad v. Chernaya*, 2016 N.Y. Misc. LEXIS 2586 (N.Y. Co. July 7, 2016), the plaintiff sued to recover on a judgment, specifically, against a $7.3 million loan the defendants owed to the judgment debtor. In their defense, defendants asserted that payment was a business distribution, not a loan. Justice Anil Singh of the New York County Commercial Division held the defendants were estopped from claiming that $7.3 million was a distribution and not a loan because their tax returns failed to report that receipt as income. The court explained: "In order to establish a prima facie case under the doctrine of tax estoppel, it must be shown that the party had an obligation to report the income on her tax return."

Likewise, in *Gliklad v. Kessler*, 2016 N.Y. Misc. LEXIS 2583 (N.Y. Co. July 7, 2016), Justice Singh found tax estoppel precluded the defendant from asserting a conveyance to him was compensation and not a gift, when his tax return categorized it as a gift. *See also Zemel v.Horowitz*, 11 Misc.3d 1058[A], 1058A, 2006 NY Slip Op 50276[U], *1 (N.Y. Co. 2006) (plaintiffs estopped from labeling a transaction as a loan where the plaintiffs had previously filed a federal tax return indicating that the transaction was a short sale of stock).

The doctrine has been applied not just to numbers and calculations in tax returns, but to other statements of fact. For example, in *Epiphany Community Nursery Sch. v. Levey*, 2017 N.Y. Misc. LEXIS 2981, *19 n. 21 (N.Y. Co. Aug. 7, 2017), Justice Shirley Kornreich of the New York County Commercial Division held that the plaintiff school was estopped from arguing that the defendant was a member of its board because plaintiff's tax filings consistently listed only two other people as the board members: "One cannot lie to the government (under penalty of perjury) and then proffer a different story in a civil action."

In *Capizzi v. Brown Chiari*, 2019 N.Y. Misc. LEXIS 4953 (Erie Co. Sept. 13, 2019), the plaintiff successfully used tax estoppel to establish that he was an equity partner in the defendant law firm at the time he resigned. Justice Timothy Walker of the Erie County Commercial Division held that the defendants were estopped from denying certain facts set forth in the law firm's tax returns, in which the plaintiff was identified as a partner who received a K-1 with a capital account.

Notably, as the court observed, there were facts in the trial record which did not favor a finding that the plaintiff continued as a partner, but the court noted that its decision was based on a totality of the evidence, including the tax returns.

Limits of the doctrine

While tax estoppel can be an effective weapon for litigants, it does have its limits. Recent Commercial Division decisions illuminate some bounds of this doctrine.

For the doctrine to apply, the facts a party asserts in litigation must be clearly inconsistent with facts in that party's tax returns. In *Shyer v. Shyer*, 2020 NY Slip Op 30252[U], *14 (N.Y. Co. 2020), a shareholder's estate claimed that the corporation had exercised its contractual right to buy back his shares at a price and in a manner inconsistent with the parties' contracts. The corporation moved for summary judgment on the grounds of tax estoppel, arguing that the shareholder's arguments were inconsistent with his tax returns.

In denying the application of tax estoppel, Justice Joel Cohen of the New York County Commercial Division reasoned that "tax estoppel applies to *factual* inconsistencies, not the legal meaning of certain facts." Here, the shareholder was not disputing how much money was received, but instead was disputing the proprietary of the calculations: "Tax estoppel prevents someone [] from reporting income on tax returns and then arguing in court that he or she received none; it does not prevent someone, however, from arguing that he or she should have received more, but for some illegal act."

Likewise, in *Madison 465 W LLC v. Dillon*, 2021 NY Slip Op 30902[U], *6 (N.Y. Co. March 22, 2021), the plaintiffs claimed that they had overpaid the defendant for a residential allowance for temporarily vacating a floor of her apartment, which she used as an office and art gallery. In asserting tax estoppel, plaintiffs relied on defendant's business tax return on which it claimed a tax deduction for rent. The deduction was not on its face inconsistent with plaintiff's overpayment argument because the deduction covered multiple premises.

From that figure, however, plaintiffs engaged in a series of calculations in an attempt to demonstrate the overpayment. In rejecting the application of tax estoppel, Justice Joel Cohen held that the plaintiffs' calculations lacked adequate evidentiary support, and were inconsistent with other evidence, including the expert opinion of defendant's accountant.

Matter of Cusimano, 2011 NY Slip Op 34206[U], *7-8 (Nassau Co. 2011), presented another interesting issue—whether tax estoppel can provide a basis to vacate an arbitration award. The petitioner moved to vacate an arbitration award over the dissolution of a limited partnership on the grounds that the arbitrators had failed to apply tax estoppel to preclude petitioners from contesting the number of partnership shares reported in eight years of tax forms.

The petitioner argued that tax estoppel is a strong public policy and that, under CPLR 7511, where an arbitral award is in clear violation of a public policy, it is subject to vacatur. In rejecting this argument, recognizing the deference that courts give to arbitration awards, the court held that tax estoppel was an evidentiary rule applied by courts through their equitable powers, and the court was disinclined to second guess the arbitrators' weighing of equitable factors.

In *Friedman v. Markowits*, 2016 N.Y. Misc. Lexis 5191 (Nassau Co. May 5, 2016), Justice Timothy Driscoll of the Nassau County Commercial Division was faced with competing tax estoppel arguments. The issue was whether the plaintiff had an ownership interest in the defendant limited liability corporations to give him standing to sue. The defense asserted tax estoppel relying on the plaintiff 's tax returns reflecting the closing of his sale of the company and the partial payment to him of certain installment sale proceeds. However, the court observed that plaintiff 's tax returns reflected only partial payment of the sales price.

In turn, the plaintiff relied on the defendant's tax returns which reflected that he continued to have an ownership interest. The court cited appellate division precedent that tax returns are not necessarily dipositive of corporate ownership. *See In the Matter of Bhanji*, 99 A.D.3d 587 (1st Dept. 2012) (respondent's federal tax return showing petitioner as a 50% owner not determinative, particularly where respondent's city tax return stated otherwise and petitioner declined to submit her own tax returns). Based on that precedent, the defendant's tax returns, the plaintiff 's tax returns and other evidence, the court determined that plaintiff continued to have an ownership interest.

Conclusion

Recent Commercial Division cases refl ect that, in certain cases, the application of tax estoppel can be straight forward. The clearest application of the doctrine surfaces when a party is asserting a position on income inconsistent with his or her tax returns. It has been recognized, however, that simply reporting amounts as income may not establish that the calculation of that income was correct.

And in other situations the application of tax estoppel is more nuanced, causing courts to examine and weigh the evidence beyond the tax returns. In any event, litigants attempting to utilize the doctrine may not want to rely on tax estoppel alone. It would be prudent to gather and submit other evidence supporting the litigation position asserted, including, where applicable, accounting expert opinions.

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