

Notice

CC-2005-012

June 07, 2005

Subject: Revised Procedures for Proving
Fraud After a Criminal Conviction

Cancel Date: Upon incorporation
into CCDM

Purpose

This Notice describes the use of collateral estoppel to narrow issues for trial in a civil fraud case when the petitioner has been convicted of tax evasion, willful failure to file a return, or filing a false return.

Background

The civil fraud penalty under section 6663 is imposed when (a) there is an underpayment of the tax required to be shown on the return; and (b) some part of that underpayment is due to the taxpayer's specific purpose of avoiding or evading a tax known or believed to be owing. *Estate of Trompeter v. Commissioner*, 279 F.3d 767, 773 (9th Cir. 2002); *Stoltzfus v. United States*, 398 F.2d 1002, 1004 (3d Cir. 1968); *Rowlee v. Commissioner*, 80 T.C. 1111, 1123 (1983). The Service must establish the elements of civil fraud by clear and convincing evidence. Section 7454(a); T.C. Rule 142(b). In other words, the Service must show by clear and convincing evidence that the petitioner underpaid the tax and that some part of the underpayment was due to fraud. *Clayton v. Commissioner*, 102 T.C. 632, 646 (1994); *Recklitis v. Commissioner*, 91 T.C. 874, 909 (1988).

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Proving Fraud After a Criminal Conviction

35.2.2.4.5 Collateral Estoppel in Fraud Cases with Prior Criminal Conviction (xxxx-xxxx)

35.2.2.4.5.1 Elements of Civil and Criminal Fraud and General Rules

(1) In general, the case should be carefully evaluated to determine whether collateral estoppel may be pleaded as to any year pending in the Tax Court if for the same year a judgment of conviction for criminal tax evasion of the same tax has been entered against the petitioner, or the officers of a corporation for the criminal tax evasion of the same tax of a corporate petitioner. Collateral estoppel should not be pleaded if the judgment of conviction is based upon a *nolo contendere* plea. *Blohm v. Commissioner*, 994 F.2d 1542, 1554 (11th Cir. 1993); *Yarbrough Oldsmobile Cadillac, Inc. v. Commissioner*, T.C. Memo. 1993-20. A "nolo" plea and resulting conviction can be used for impeachment purposes, however. Fed. R. Crim. Proc. 11(f); Fed. R. Evid. 410; *Hicks v. Commissioner*, 56 T.C. 982, 1027, *aff'd*, 470 F.2d 87 (1st Cir. 1972). For the purposes of applying collateral estoppel, a conviction can be based either upon a trial on the merits or a guilty plea. *Gray v. Commissioner*, 708 F.2d 243, 246 (6th Cir. 1983); *Moore v. Commissioner*, T.C. Memo. 2001-77. Collateral estoppel is not applicable with respect to the petitioner's individual tax liability, if the petitioner is an individual who has been convicted for evasion of a corporate tax only. If it is concluded that collateral estoppel should be pleaded, the supporting facts should be pleaded in the answer in support of the civil fraud penalty.

(2) To support collateral estoppel, there should be a showing that a court of competent jurisdiction has entered a final judgment of conviction, other than one based upon a *nolo contendere* plea, in a case between parties who are the same as, or in privity with, the parties to the Tax Court case, and that the facts or issues were either presented and actually determined in the prior criminal case, or were essential to support the judgment entered therein. See Exhibit 35.11.1-50. Collateral estoppel applies to establish liability for the addition to tax for fraud, and to establish any other facts or issues actually determined in the criminal case or essential to support the judgment therein, such as the existence of an understatement of tax which is due to fraud. Collateral estoppel is premised upon the judgment entered in the other case. The judgment of conviction, as well as the indictment or information, should be either set forth verbatim in the answer or a copy thereof attached as an exhibit to the answer.

(3) It is well established that a conviction for criminal tax evasion under section 7201 after a trial on the merits (or a guilty plea) collaterally estops the convicted taxpayer from subsequently denying the specific intent requirement of civil fraud under section 6663. See *Amos v. Commissioner*, 43 T.C. 50 (1964). Because a criminal conviction under section 7201 does not require the determination of an exact tax liability (see *Moore v. United States*, 360 F.2d 353, 356-57 (4th Cir. 1965); *Wapnick v.*

Commissioner, T.C. Memo. 1997-133), the petitioner is not estopped from disputing the amount of the underpayment. A conviction under section 7201 based on failure to file a return will constitute collateral estoppel for the fraud delinquency penalty provided by section 6651(f). *Madge v. Commissioner*, T.C. Memo. 2000-370, *aff'd by unpub. opin.*, 23 Fed Appx. 604 (8th Cir. 2001); *Unger v. Commissioner*, T.C. Memo. 2000-267; *Wallace v. Commissioner*, T.C. Memo. 2000-49.

(4) A conviction under section 7203 for willfully failing to file tax returns may be used to prevent a petitioner from challenging the addition to tax under section 6651(a)(1) for failure to file. See *Kotmair v. Commissioner*, 86 T.C. 1253 (1986). A conviction under section 7203 does not, however, constitute collateral estoppel as to the fraud delinquency penalty under section 6651(f). *Wilkinson v. Commissioner*, T.C. Memo. 1997-410. If the taxpayer has been convicted under section 7203, collateral estoppel and summary judgment procedures similar to those described below with respect to section 7206(1) convictions should be followed to narrow the issues in a Tax Court case involving the fraud delinquency penalty.

(5) For a conviction under section 7206(1), the government must prove that the taxpayer: (1) filed a return, statement, or other document that was false as to a material matter; (2) signed the return, statement, or other document under penalty of perjury; (3) did not believe the return, statement, or other document was true as to every material matter; and (4) willfully subscribed to the false return with the specific intent to violate the law. *United States v. Hanson*, 2 F.3d 942, 945 (9th Cir. 1993). A criminal conviction under section 7206(1) for willfully filing a false return does not estop the petitioner from challenging a civil fraud penalty in the year of the conviction. See *Wright v. Commissioner*, 84 T.C. 636 (1985). The holding in *Wright* is based on the fact that the element of intent to evade tax is present in section 6663,¹ but not in section 7206(1). Although not conclusive as to fraud,² the conviction is admissible as evidence of fraud. *Wright* at 643-44. The conviction does estop the petitioner from denying that petitioner willfully filed false income tax returns.

35.2.2.4.5.2 Pleading Collateral Estoppel

(1) Collateral estoppel is an affirmative defense that must be pled in the answer. Because the respondent bears the burden of proof with respect to fraud, affirmative allegations supporting fraud must also be pled in the answer. Thus, for cases involving both conviction and nonconviction years, it is essential to plead adequately all facts supporting the fraud penalty for the nonconviction years. Even though collateral

¹ The issue in *Wright* involved former section 6653(b), the predecessor to section 6663.

² The term "intent to evade tax" is synonymous with "fraud." See *Mitchell v. Commissioner*, 118 F.2d 308, 310 (5th Cir. 1941) ("Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing.").

estoppel applies to the conviction years, the factual evidence of fraud in the year or years covered by estoppel is admissible for the purpose of establishing a pattern consistent with the arguments for the years not covered by collateral estoppel. Thus, in that type of case, and particularly in cases involving net worth determinations or cases in which it is necessary to show a pattern of tax omission, the facts evidencing fraud should be pleaded for all years. See Exhibits 35.11.1-52 and 35.11.1-53; *Williams v. Commissioner*, T.C. Memo. 1991-521.

(2) If the original answer is filed prior to the indictment or disposition of the related criminal case, an amended answer, together with a motion for leave to file, should be filed in order to plead the facts as may be appropriate as a result of the disposition of the related criminal case.

35.2.2.4.5.3 Narrowing the Issues for Trial – Pleadings Based on a Section 7206(1) Conviction

(1) If a taxpayer is convicted under section 7206(1) for willfully misstating a matter on a return that affects the computation of the tax owed, the conviction may be used to narrow the issues for trial in the Tax Court. If the willful misstatement was a willful underreporting of income, collateral estoppel should be pled to establish the fact that the petitioner willfully underreported income. Once that fact is established, the petitioner may not defend against a finding of fraud by contending that he did not willfully underreport income. *Miller v. Commissioner*, T.C. Memo. 1989-461. Furthermore, it may be argued that the obvious purpose and the result of willfully underreporting income is to intentionally avoid paying tax known to be due on the omitted income.

(2) If the basis of a conviction under section 7206(1) was overstated deductions or some other factual basis with a direct nexus to the petitioner's tax liability, an analogous analysis applies. Collateral estoppel should be pled to establish the factual basis – e.g., the overstatement of deductions – and thereby preclude the petitioner from arguing facts that are inconsistent with the factual basis of the section 7206(1) conviction.

(3) The criminal case will have collateral estoppel effect in the civil case only with respect to the facts that were necessary to support the criminal conviction as charged in the indictment or information. For example, if the petitioner had been convicted of violating section 7206(1) by filing a false return that understated income, the conviction would not collaterally estop the petitioner from claiming that disallowed deductions were not willfully overstated or that some portion of unreported income was not willfully underreported. Accordingly, case analysis and development should establish whether the civil case involves disputes over types of income, deductions, or other tax items that were not necessarily decided in the criminal case.

(4) Collateral estoppel should be pled in the answer, and should include that the petitioner is collaterally estopped from claiming not to have known at the time the return was filed that the return understated income, overstated deductions, or included or

excluded some other tax item, as appropriate based on the petitioner's conviction. See Exhibit 35.11.1-55A.

(5) A copy of the indictment (or bill of information), the judgment and conviction (or plea agreement), the closing statements, the jury charges, and the jury verdicts from the criminal case should be obtained. The indictment and judgment and conviction should be set forth verbatim in the answer or attached as an exhibit to the answer. If the criminal case was appealed, a citation to the appellate opinion should also be included in the answer.

35.2.2.4.5.4 Motions for Summary Judgment

(1) The fact that the petitioner intended to evade tax will need to be established by clear and convincing evidence. The fact that the petitioner knowingly and willfully understated income (or overstated deductions, etc.) should be in the record. This fact would have been established during the criminal proceedings, and the petitioner will be collaterally estopped from denying this fact in the Tax Court proceeding.

(2) The link between the petitioner's understatement of income (or overstatement of deductions, etc.) and the petitioner's knowledge that an understatement of income (or overstatement of deductions, etc.) on the return would result in an underreporting of tax liability must be established.

(3) The petitioner's tax and financial background, educational level, and general business sophistication must be established through stipulations, admissions, interrogatories, and other discovery methods. The more educated, knowledgeable, experienced, and sophisticated a petitioner is, the less likely the petitioner failed to understand the link between understatement of income (or overstatement of deductions) and underreporting of tax.

(4) Once sufficient facts are established to show that the petitioner knew the willfully false statement on the tax return would result in an underpayment of tax and, therefore, intended to avoid or evade tax at the time the false statement was made, a motion for summary judgment, or partial summary judgment, as appropriate, should be filed. The motion for summary judgment should include the following general arguments: First, the petitioner knowingly understated income. Second, Facts A, B, and C, established by joint stipulations, admissions, etc., show that the understated income that was the basis of the false return in the petitioner's criminal case is the same as the understated income leading to the underreporting of tax liability in this Tax Court case. Third, Facts X, Y, and Z, established by joint stipulations, admissions, etc., show that the petitioner knew at the time the return was filed that an understatement of income would result in an underreporting of tax liability. Fourth, a prima facie showing of fraud under section 6663 is established. Therefore, unless the petitioner can come forward with evidence to rebut the prima facie showing, the requisite intent to evade tax exists, and the court should find the petitioner liable for the section 6663 fraud penalty.

Questions concerning this notice may be directed to Branch 2, Administrative Procedure & Judicial Practice Division, Procedure and Administration, at 202-622-4940.

_____/s/_____
Deborah A. Butler
Associate Chief Counsel
(Procedure & Administration)

Exhibit 35.11.1 -55A

Answer - Affirmative Allegations: Civil Fraud Penalty - Collateral Estoppel of Certain Issues After a Criminal Conviction under Section 7206(1)

8. FURTHER ANSWERING the petition, and in support of the determination that a part of the underpayment of tax required to be shown on petitioner's income tax return for the taxable year [year] is due to fraud, respondent affirmatively relies upon the doctrine of collateral estoppel (issue preclusion), and alleges:

(a) [Name], petitioner herein, is the same person who was the defendant in the criminal case of United States of America v. [name] [court, Docket No.]. The judgment entered in that case became final on [date].

(b) Respondent is a party in privity with the United States of America, the prosecuting party in the criminal case described above in which petitioner was the defendant.

(c) The indictment filed on [date], in that criminal case, set forth the following charge against petitioner:

THE GRAND JURY CHARGES:

That on or about [date], in [city], [state], [name], a resident of [city], [state], did willfully make and subscribe a U.S. Individual Income Tax Return for the calendar year [year], which was verified by a written declaration that it was made under the penalties of perjury and was filed with the Internal Revenue Service, at [city], [state], which said income tax return he [she] did not believe to be true and correct as to every material matter in that the said return reported [state each false item of income reported, e.g. dividend income in the amount of \$, interest income in the amount of \$,] whereas, as he [she] then and there well knew and believed, he [she] received [state each item] in addition to that heretofore stated; in violation of Title 26, United States Code, Section 7206(1).

(d) Petitioner on [date], entered a plea of guilty to the charge set forth against him [her] in the indictment.

(e) On [date], the United States District Court entered its judgment pursuant to the guilty plea, a certified copy of which is attached hereto as Exhibit A.

(f) Among the issues of fact determined in the criminal case was whether petitioner did in fact willfully and knowingly file a false income tax return for the taxable year [year], and whether he [she] did in fact by such means understate his [her] income for that year.

(g) One of the issues in the instant case is whether the addition to the tax imposed by section 6663(a) should be imposed against petitioner for the taxable year [year].

(h) An issue in the instant case is the same as an issue which was presented and determined adversely to petitioner in the criminal case to the extent that the imposition of the addition to the tax against petitioner for the taxable year [year], under section 6663(a), and the judgment of conviction of petitioner for violation of section 7206(1), are each dependent upon findings that petitioner for that taxable year did in fact willfully and knowingly file a false income tax return for that year and that he [she] did in fact by such means understate a part of the income realized by him [her] for that year.

(i) The prior criminal conviction of petitioner under section 7206(1) for the taxable year [year] is conclusive and binding on petitioner, and by reason thereof petitioner is estopped in the instant case, under the doctrine of collateral estoppel (issue preclusion), from denying that he [she] willfully and knowingly filed a false income tax return for the taxable year [year] and that the return understated income.

WHEREFORE, respondent prays that . . .

(x) the court determine that for taxable year [year] petitioner is estopped under the doctrine of collateral estoppel (issue preclusion) from denying that petitioner did willfully and knowingly file a false income tax return and by such means understated income for that year.