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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ALBERT B. KERKHOVE
Associate Area Counsel
CC:SB:5:OMA

FROM: Curtis G. Wilson
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CC:PA:APJP

SUBJECT: Effect of Sentencing Hearing

This Chief Counsel Advice responds to your memorandum dated October 31, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

X =
Y =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

Co. A =
Co. B =

ISSUE

In sentencing X and Y after they were convicted of violating 7206(1) of the Internal Revenue Code for Years 3, 4, and 5, a court found that they did not willfully fail to

report certain income for those years. Does this finding preclude the Commissioner of Internal Revenue from asserting a civil fraud penalty against X and Y for failing to report that income?

CONCLUSION

The sentencing finding does not preclude the Commissioner. The issues are different and applicable rules are different.

FACTS

During Years 1, 2, 3, 4, and 5, X and Y owned and operated a business, Co. A. During these same years, X and Y also owned and operated a second business, Co. B.

The reporting of income from Co. A and Co. B led to an indictment against X and Y. A federal district court jury convicted them of violating section 7206(1) by submitting false tax returns for Years 3, 4, and 5. At the sentencing hearing, the court found that X and Y had failed to report the income from both Co. A and Co. B, but held them criminally responsible only for willfully failing to report income from Co. A. The court, however, did state that the guilt of the defendants was not at issue as the jury found beyond a reasonable doubt that X and Y were guilty. The court further explained that, while it was in its power to set the verdict aside if it found the evidence inadequate, there was no question that the evidence was adequate to support the verdict. As there was a general verdict, the court pointed out that it would not be possible to know whether the jury believed X and Y were guilty of fraud with respect to both Co. A and Co. B, or guilty with respect to only one of the two companies. Consequently, the court sentenced X and Y based only on the tax loss attributable to their willful failure to report income from Co. A.

After the sentencing, the Internal Revenue Service issued a statutory notice of deficiency to X and Y, asserting a civil fraud penalty for Years 1, 2, 3, 4, and 5 on the income from both Co. A and Co. B. X and Y petitioned the United States Tax Court. X and Y admit they were convicted of filing false returns under section 7206(1) for Years 3, 4 and 5. They further admit to a substantial underreporting of income for Years 1 through 5 and have admitted filing false returns for Years 3, 4 and 5. They argue, however, that the Commissioner of Internal Revenue is precluded by the prior court proceeding, specifically, the sentencing hearing, from asserting a civil fraud penalty on the income from Co. B.

LAW AND ANALYSIS

In analyzing the effect of the sentencing court's findings, we begin by comparing the elements of sections 7206(1) and 6663 and noting the relationship between the two provisions. As pertinent, section 7206 provides as follows:

Any person who—

(1) Declaration under penalties of perjury. 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 . . .

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$ 500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Section 6663 imposes a civil fraud penalty under the following circumstances:

(a) Imposition of penalty. If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

(b) Determination of portion attributable to fraud. If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

(c) Special rule for joint returns. In the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

The intent to evade tax is not an element of the crime charged under section 7206(1). Wright v. Commissioner, 84 T.C. 636, 643 (1985), acq. in part, 1988-2 C.B. 1. In contrast, fraud is established by proof of intent to evade a tax believed to be owing. Clayton v. Commissioner, 102 T.C. 632, 646 (1994). Although not conclusive, a conviction for filing false tax returns is evidence of fraud. Wright, 84 T.C. at 643-44.

The conviction of X and Y for filing false tax returns for Years 3, 4, and 5 is, therefore, a fact to be considered in their trial under section 6663. But X and Y argue that the Commissioner is barred by the findings at the sentencing hearing from proving fraud for those years as to their income from Co. B.

A conviction under section 7206(1) does not establish as a matter of law that the taxpayer violated his legal duty with an intent, or in an attempt, to evade taxes. Wright, 84 T.C. at 643. The conviction for filing of false returns is admissible as evidence of fraud. Id. Here, X and Y admit they were convicted of filing false returns under section 7206(1) for Years 3, 4 and 5.

In this case, X and Y have admitted a substantial underreporting of income for Years 1 through 5 and have admitted filing false returns for Years 3, 4 and 5. The Commissioner, however, must still prove by clear and convincing evidence that a portion of the unreported income in each year was due to fraud. If the Commissioner is able to meet this burden, the burden would then shift to X and Y to show, by a preponderance of the evidence, that some portion of the unreported income is not attributable to fraud. I.R.C. Section 6663(b).

The doctrines of res judicata and collateral estoppel dictate how an earlier court proceeding effects subsequent litigation.

A fundamental precept of common-law adjudication, embodied in the related doctrines of collateral estoppel and res judicata, is that a "right, question or fact distinctly put in issue and directly determined by a court of competent jurisdiction . . . cannot be disputed in a subsequent suit between the same parties or their privies . . ." Southern Pacific R. Co. v. United States, 168 U.S. 1, 48-49 (1897). Under res judicata, a final judgment on the merits bars further claims by parties or their privies based on the same cause of action. Cromwell v. County of Sac, 94 U.S. 351, 352 (1877); Lawlor v. National Screen Service Corp., 349 U.S. 322, 326 (1955); 1B J. Moore, Federal Practice para. 0.405[1], pp. 621-624 (2d ed. 1974) (hereinafter 1B Moore); Restatement (Second) of Judgments Section 47 (Tent. Draft No. 1, Mar. 28, 1973) (merger); id., Section 48 (bar). Under collateral estoppel, once an issue is actually and necessarily determined by a court of competent jurisdiction, that determination is conclusive in subsequent suits based on a different cause of action involving a party to the prior litigation. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 n. 5 (1979); Scott, Collateral Estoppel by Judgment, 56 Harv. L. Rev. 1, 2-3 (1942); Restatement (Second) of Judgments Section 68 (Tent. Draft No. 4, Apr. 15, 1977) (issue preclusion). Application of both doctrines is central to the purpose for which civil courts have been established, the conclusive resolution of disputes within their jurisdictions. Southern Pacific R. Co., supra, at 49; Hart Steel Co. v. Railroad Supply Co., 244 U.S. 294, 299 (1917). To preclude parties from contesting matters that they have had a full and fair opportunity to litigate protects their adversaries from the expense and vexation attending multiple lawsuits, conserves judicial resources, and fosters reliance on judicial action by minimizing the possibility of inconsistent decisions.

Montana v. United States, 440 U.S. 147, 153-54 (1979).

The Tax Court has adopted a five-part test for collateral estoppel. Peck v. Commissioner, 90 T.C. 162, 166-67 (1988). Before applying the Peck test in this case, an understanding of the rules and procedures used in a sentencing hearing in a federal criminal case, and especially in a federal tax crime case, is required.

First, the rules of evidence are relaxed. The sentencing court may take into account any evidence that it finds credible. See 18 U.S.C. section 3661; United States v. Watts, 519 U.S. 148, 152-53 (1997). The sentencing guidelines state that "in resolving any dispute concerning a factor important to the sentencing determination, the Court may consider relevant information without regard to its admissibility under the rules of evidence applicable at trial, provided that the information has sufficient indicia of reliability to support its probable accuracy." USSG section 6A1.3.(a) and comment.

Second, the court in a sentencing hearing normally uses a burden of proof of the preponderance of the evidence. USSG Section 6A1.3, comment.; United States v. Urrego-Linares, 879 F.2d 1234, 1237 (4th Cir. 1989).

Third, discovery is limited in a criminal case. See Fed. R. Crim. P. 16. There is no discovery for a sentencing hearing with the exception that the government attorney has access to the presentence report prepared by the probation officer. See Fed. R. Crim. P. 32.

Fourth, the judgment or conviction in a criminal tax case is not based on the tax loss amount used at a sentencing hearing for sentencing purposes. Neither the criminal tax loss nor a tax deficiency is an element of the crime of filing a false return under section 7206(1). See Wright, 84 T.C. at 643.

Fifth, the higher "standard of proof imposed on the Government in criminal proceedings commonly results in the use of taxable income figures for purposes of a criminal prosecution that are different from those used for civil purposes in determining the taxpayer's corrected federal income tax liability." Schwener v. Commissioner, T.C. Memo. 1987-594 (citing One Lot Emerald Cut Stones and One Ring v. United States, 409 U.S. 232, 235 (1972), and Helvering v. Mitchell, 303 U.S. 391, 402-03 (1938)).

Sixth, the sentencing guidelines recognize that the tax loss will not be "reasonably ascertainable." See USSG section 2T1.1, comment. (n.1). Although the government bears the burden at sentencing of proving the amount of tax loss flowing from the defendant's illegal acts, neither the government nor the court has an obligation to calculate the tax loss with certainty or precision. United States v. Spencer, 178 F.3d 1365, 1368 (10th Cir. 1999). Moreover, in tax loss calculations under the sentencing guidelines, an individual's tax liability is not computed as is done in a traditional audit. Rather, the tax loss resulting from the manner in which the defendant chose to complete income tax returns is calculated. See USSG section 2T1.1(c)(1).

Collateral Estoppel Does Not Apply in this Case

As this case is before the Tax Court, it is appropriate to apply the Peck requirements to the facts.

(1) Is the issue in the second suit identical in all respects with the one decided in the first suit? Answer: No.

The issue in the criminal case was whether X and Y were guilty of violating section 7206(1). The issue in the civil case is the specific amount of X and Y's tax deficiency, and whether they are subject to a civil fraud penalty as authorized by section 6663. The conviction in the criminal tax case was not based on whether there was a tax loss. Neither the tax loss used in the sentencing hearing nor the tax deficiency proposed in the notice of deficiency was an element of the crime for which X and Y were convicted. See Wright, 84 T.C. 636. Therefore, the issues are not the same in the two cases.

(2) Was there are a final judgment rendered by a court of competent jurisdiction? Answer: Yes.

The sentencing court was a federal district court, a court of competent jurisdiction. The final judgment, of conviction and of sentencing, was a determination by a court of competent jurisdiction.

(3) Were the parties in the criminal case and the pending civil case the same parties or were they privies to parties in the prior criminal case? Answer: Yes

X and Y and the United States were the parties in the prior criminal case. X and Y and the Commissioner are the parties in the pending civil case. The Commissioner of Internal Revenue is a party in privity with the United States in this case.

(4) Did the parties actually litigate the issues and was the resolution of the issues essential to the prior decision? Answer: No, as to the sentencing hearing.

The issue in the civil case, as it relates to X and Y's collateral estoppel claim, is whether the Commissioner is precluded from asserting a fraud penalty for Co. B based on the finding at the sentencing hearing that X and Y did not willfully fail to report the income for Co. B. The threshold question is whether the parties actually litigated the issue in the pending civil case. The issue litigated at trial was whether X and Y willfully failed to report income on their income tax returns. A jury found X and Y guilty of this offense for both Co. A and Co. B. However, the issue at the sentencing hearing was to determine the proper punishment for X and Y for their illegal conduct based on all the relevant factors. See United States v. Education Dev. Network, Civ.A. No. 89-7780, 1993 U.S. Dist. LEXIS 18013 (E.D. Pa. 1993); United States v. Mickman, Civ.A. No. 89-7826, 1993 U.S. Dist. LEXIS 18200 (E.D. Pa. 1993) aff'd without op., 52 F.3d 318 (3d Cir. 1995). The sentencing hearing

determined the criminal tax loss, not the civil tax liability. The civil tax liability for X and Y was neither actually, nor necessarily, litigated in the criminal case nor at the sentencing hearing. See In re Minkoff, 85 A.F.T.R.2d 449 (Bankr. D. Kan. 1999). Additionally, as previously mentioned, the government does not have an obligation to calculate the tax loss with certainty or precision at a sentencing hearing. Spencer, 178 F.3d at 1368. Therefore, the Government is not barred from asserting a fraud penalty based on the conclusions from the sentencing hearing because the parties did not actually litigate the issue at the sentencing hearing.

(5) Are the controlling facts and applicable legal rules the same in the civil tax proceeding as they were in the criminal sentencing hearing? Answer: No.

First, the rules of evidence are different in the two proceedings. The rules of evidence are relaxed in a sentencing hearing but must be fully complied with in a Tax Court case. Both the government and X and Y will be held to strict evidentiary rules in the pending civil case. See Tax Court Rule 143(a); I.R.C. section 7453. The determination by the sentencing judge was made under relaxed rules, and the sentencing court could take into account any evidence that it found credible. 18 U.S.C. section 3661; USSG section 6A1.3.; Watts, 519 U.S. at 152-53.

Second, the burden of proof is different. The burden of proof standard in the main criminal proceeding, the jury proceeding, was beyond a reasonable doubt. The standard in the sentencing hearing was the preponderance of the evidence. USSG section 6A1.3 comment. The standard in this civil proceeding as to the fraud penalties is clear and convincing evidence. I.R.C. section 6663.

Third, the discovery procedures are different. Discovery is limited in a criminal case. See Fed. R. Crim. P. 16. There is no discovery for a sentencing hearing with the exception of the government attorney having access to the presentence report prepared by the probation officer. See Fed. R. Crim. P. 32. In the pending civil tax proceeding, the Commissioner will have numerous discovery options available to ensure that it obtains all of the documents and information available from X and Y, or other entities, that are related to X and Y's tax liability for Years 1 through 5. See Tax Court Rules 70 through 104. The additional information available to the Commissioner has the potential to include documents or information that will convince the Tax Court that the civil fraud penalty is appropriate for all of the proposed adjustments for all years at issue.

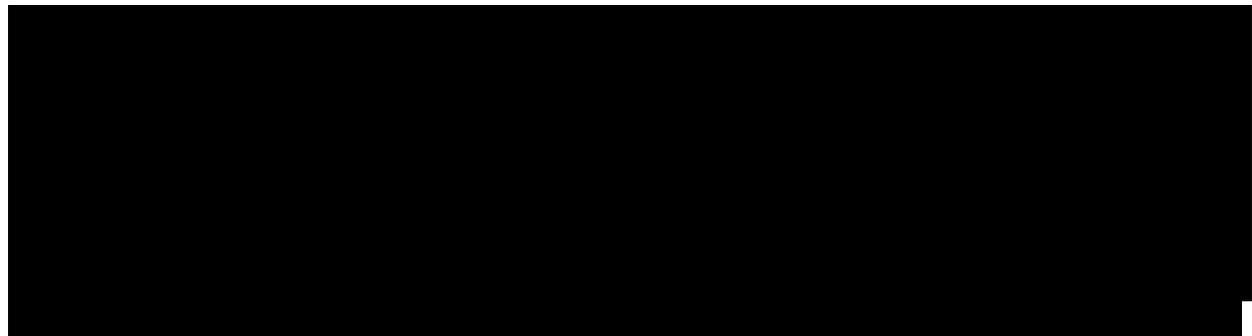
The United States Court of Appeals for the Second Circuit, in S.E.C. v. Monarch Funding Corp., 192 F.3d 295 (2d Cir. 1999), has considered whether findings in criminal sentencing hearing should preclude relitigation of issues considered in the sentencing hearing. The court first extensively analyzed the general application of collateral estoppel to sentencing hearings. The court generally concluded that precluding relitigation on the basis of findings in a sentencing hearing should be presumed improper. The court did not foreclose the application of collateral

estoppel to sentencing hearing where it is clearly fair and efficient to do so. The court stated that the burden should be on the plaintiffs, in this case X and Y, to prove the elements of collateral estoppel.

The United States Court of Appeals for the Tenth Circuit, in United States v. Barnette, 10 F.3d 1553, 1560-62 (10th Cir. 1994), refused to allow a defendant to use collateral estoppel or res judicata to prevent the United States from claiming more damages in a civil case than were ordered as restitution in the related criminal case. The court determined that the laws and the burden of proof were different in the criminal and civil cases.

For the reasons stated above, the Commissioner is not precluded from asserting the civil fraud penalty, with respect to the asserted unreported income from Co. B.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

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