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Income Taxes: Collateral Estoppel Applied to the Civil Fraud Penalty

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INCOME TAXES: COLLATERAL ESTOPPEL APPLIED TO THE CIVIL FRAUD PENALTY

A husband was convicted of willfully attempting to evade his income taxes in violation of Section 145(b) of the Internal Revenue Code of 1939.[1] Subsequently, upon the filing of a joint return, the Internal Revenue Service assessed the fifty percent fraud penalty jointly against the taxpayer-husband and his wife pursuant to Section 293(b) of the Internal Revenue Code of 1939.[2] The penalties were paid, and the taxpayers brought suit for a refund. The sole evidence introduced by the government at the trial was a certified copy of the criminal indictment, judgment and commitment against the taxpayer-husband. The trial court permitted the husband's prior criminal conviction for willfully attempting to evade his income taxes to operate as a collateral estoppel, foreclosing him and his wife from relitigating the issue of fraud for those taxable years. On appeal, *held*, affirmed. The term "willfully" as used in Section 145(b) necessarily includes the elements of "fraud" as used in Section 293(b). Accordingly, the doctrine of collateral estoppel forecloses relitigation of the factual issue of fraud. *Tomlinson v. Lefkowitz*, 334 F.2d 262 (5th Cir. 1964).

Collateral estoppel is an adjunct to the ancient judicial doctrine of res judicata.[3] The principle of res judicata applies only when the same cause of action arises between the same parties.[4] Collateral estoppel, on the other hand, operates in different causes of action as to all matters which were in issue or were controverted in the prior litigation and

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1. The text provides:

Any person . . . who willfully attempts in any manner to *evade* or *defeat* any tax imposed by this chapter or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution. (Emphasis supplied.)

INT. REV. CODE of 1954 § 7201 is substantially the same.

2. The text is as follows:

If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2).

INT. REV. CODE OF 1954 § 6653(b) although not identical, is substantially the same.

3. Cromwell v. County of SAC, 94 U.S. 351 (1876). It is vital to recognize the distinction beween the effect of a judgment upon the cause of action on which the judgment is based (res judicata) and its effect upon a subsequent controversy between the parties based upon a different cause of action (collateral estoppel). Generally, a judgment puts an end to the cause of action which is the basis of the proceeding in which the judgment is rendered. See RESTATEMENT, JUDGMENTS § 68 (1942). However, a judgment can effect a subsequent controversy based upon a different cause of action involving the same or some of the same questions which were involved in the original action. The original judgment is conclusive between the parties only as to matters actually litigated and determined in the prior action. It is not conclusive as to matters which might have been, but were not, actually litigated and determined. See Scott, *Collateral Estoppel by Judgment*, 56 HARV. L. REV. 1 (1942).

4. RESTATEMENT, JUDGMENTS § 68 (1942).

upon which the determination of the judgment was rendered.[5] The application of the doctrine of collateral estoppel to tax litigation has long been recognized by the Supreme Court: "Where a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination . . . even though the cause of action is different."[6] However, collateral estoppel is never applied to *every* fact determined in the first action which later becomes an issue in the second suit.[7] For the estoppel to apply conclusively in a subsequent controversy, the fact must have been *essential* to the rendition of the first judgment and be an *ultimate* fact necessary in the determination of the second suit.[8] In effect, applying collateral estoppel in tax controversies prevents relitigation of the identical question of whether a statute applies to a taxpayers' status.[9] However, it has been heretofore clearly recognized that collateral estoppel is confined to situations where the matter raised in the second suit is *identical in all respects with that decided in the first proceeding and when the controlling facts and applicable legal rules remain unchanged.*[10] As a result, where the legal matter determined in the earlier decision differs with that raised in the second controversy, collateral estoppel has no effect.[11] Similarly, when the situation *subsequently* is vitally altered after the rendition of the first judgment, the prior determination is no longer conclusive.[12] Even a judicial declaration which intervenes between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable.[13] Of course, when a question of fact essential to the prior judgment is actually litigated and determined in the first proceeding, the parties are bound by that determination in the subsequent proceeding, notwithstanding that the cause of action is different.[14] It has been estab-

5. Mercoid Corp. v. Mid-Continent Investment Co., 320 U.S. 661 (1944); Southern Pacific Ry. Co. v. United States, 168 U.S. 1 (1897); Cromwell v. County of SAC, 94 U.S. 351 (1876); Russell v. Place, 94 U.S. 606 (1876). While the doctrine of collateral estoppel may be applicable to questions of fact, it may not be conclusive as to questions of law. United States v. Stone & Downer Co., 274 U.S. 225 (1927). On the other hand, there are cases in which it has been held that a judgment is conclusive in a subsequent controversy between the same parties as to matters of law which were litigated and determined in the previous action. United States v. Moser, 266 U.S. 236 (1924).

6. Commissioner v. Sunnen, 333 U.S. 591, 601 (1948).

7. Rex v. Duchess of Kingston, 20 How St. Tr. 355 (House of Lords, 1776).

8. The Evergreens v. Nunan, 141 F.2d 927 (2d Cir. 1944). For this purpose ultimate facts are those facts upon whose combined occurrence the law raises a duty or right as distinguished from evidentiary facts or mediate datum which are those facts from which existence may be rationally inferred the existence of an ultimate fact. *Ibid.*

9. Tait v. Western Md. Ry. Co., 289 U.S. 620 (1933).

10. Commissioner v. Sunnen, 333 U.S. 591 (1948); Tait v. Western Md. Ry. Co., 289 U.S. 620 (1933).

11. Travelers Ins. Co. v. Commissioner, 161 F.2d 93 (2d Cir. 1947).

12. State Farm Ins. Co. v. Duel, 324 U.S. 154 (1945).

13. Blair v. Commissioner, 300 U.S. 5 (1937).

14. The Evergreens v. Nunan, 141 F.2d 927 (2d Cir. 1944).

lished that a prior judgment can also be conclusive as to the *legal* issues appearing in a controversy relating to different taxable years.[15]

Whether or not the statutory concept of "willfulness" was intended to encompass the "elements of fraud" has long been subject to controversy.[16] The leading Supreme Court decision on the issue, *Helvering v. Mitchell*,[17] was easily distinguished by the *Lefkowitz* tribunal.[18] In *Helvering*, the government urged that the application of the doctrine was precluded by the *difference in issues* presented in the two cases. The government had expressly contended that the issue of whether Mitchell had "willfully" attempted to evade or defeat the tax was not identical to whether he had done so "fraudulently."[19] In *Lefkowitz*, the court recognized that the *Helvering* case could not assert an estoppel on the question of fraud in a subsequent civil action founded on an *acquittal* in a prior criminal case because of the different standards of proof involved. Interestingly, in *Helvering* it was the commissioner who was seeking to avoid imposition of the collateral estoppel doctrine in order to impose a fraud penalty on a taxpayer who was previously acquitted of willfully attempting to evade income taxes. It seems that the government position on the issue is being tailored to suit its own convenience.

In a later tax court decision, the government sought collaterally to estop a taxpayer convicted of attempting to defeat and evade a portion of his income taxes from litigating the fraud penalties under Section 293(b) of the Revenue Code of 1939.[20] The tax court relied heavily on *Helvering* by pointing out that the penalties for criminal and civil fraud are essentially different in character and were enacted for wholly different purposes.[21] The tax court, at least, has been consistent. In *Vassallo*,[22] an almost identical factual situation to the *Lefkowitz* case was presented to the tax court. The court clearly established that a taxpayer's conviction under Section 145 was not res judicata in a court proceeding under Section 293(b). It would certainly appear that at the time *Lefkowitz* was decided in the federal district court, the tax court was firmly committed to the proposition that collateral estoppel would not apply.[23] Nevertheless, the federal court, in *Lefkowitz*, disregarded the

15. Stoddard v. Commissioner, 141 F.2d 76 (2d Cir. 1944); Campana Corp. v. Harrison, 135 F.2d 334 (7th Cir. 1943); Engineers' Club of Philadelphia v. United States, 95 Ct. Cl. 42, 42 F. Supp. 182 (1942).

16. Helvering v. Mitchell, 303 U.S. 391 (1938); United States v. Scharton, 285 U.S. 518 (1932); Amos, 43 T.C. 50 (1964); Safra, 30 T.C. 1026 (1958).

17. 303 U.S. 391 (1938).

18. Tomlinson v. Lefkowitz, 334 F.2d 262, 265 (5th Cir. 1964).

19. Helvering v. Mitchell, 303 U.S. 391, 398 (1938).

20. Safra, 30 T.C. 1026 (1958).

21. *Id.* at 1035.

22. 23 T.C. 656 (1955).

23. *See*, Safra v. Comm. 30 T.C. 1026, 1035 (1958), where the court specifically stated: We are aware of no decision which holds that a conviction for criminal fraud in a United States District Court estops a taxpayer from denying a determination of

tax court's view by concluding that the term "willfully" *necessarily includes* the elements of "fraud" as used in the respective statutes. In the court's view, the term "willfully," as used in the criminal statute, is a "specific intent involving the bad purpose and evil motives to evade and defeat the payment . . . of income tax."[24] Correspondingly, the fraud necessary for imposition of the fifty percent fraud penalty is a "specific purpose to avoid a tax known to be owing."[25] Clearly, the court reasoned, comparison of the components of the two terms discloses that the element of fraud is encompassed in the concept of willfullness. The difference, if any, is merely in the degree of motive or evil purpose, not in the elements themselves.[26]

Since the *Lefkowitz* decision in the federal district court, the tax court has expressly receded from its prior position in *Safra* by adopting the doctrine of collateral estoppel.[27] However, the recanting of the tax court was bitterly opposed.[28] Justice Whitney assailed the view of the bare majority as being a principle which effectively deprives a taxpayer who has been convicted under Section 7201,[29] of his constitutional right to due process of law before being deprived of his property through the use of collateral estoppel.[30]

A more intriguing problem presented by *Lefkowitz* is whether the wife could be collaterally estopped by the criminal conviction of her husband. It is uncontrovertable that a wife who is a party to a fraudulent joint return may be held liable for the fraud penalties assessed on account of her husband's fraud in preparing that return even though she had no income, did not entertain any fraudulent intent, and did not know that the return was fraudulent.[31] However, in *Lefkowitz*, no tax returns were filed prior to the husband's conviction. The delinquent joint tax returns were filed *after* the conviction and the liability reported was *accurate* and *uncontested*. Therefore, the issue presented is whether a husband's

additions to tax for fraud in a tax court proceeding and a respondent has cited none. Therefore, we are inclined to follow our previous decisions in holding that the petitioner is not collaterally estopped to deny that a portion of the deficiencies herein was due to fraud with intent to evade a tax.

24. Bloch v. United States, 221 F.2d 786, 789 (9th Cir. 1955).

25. Powell v. Granquist, 252 F.2d 56, 60 (9th Cir. 1958).

26. Tomlinson v. Lefkowitz, 334 F.2d 262 (5th Cir. 1964).

27. Amos, 43 T.C. 50 (1964).

28. *Id.* at 58, *et seq.*

29. INT. REV. CODE of 1954, corresponding to § 145(b) of the INT. REV. CODE of 1939.

30. Amos, 43 T.C. 50, 58 (1964). A federal district court in Virginia appears to have lent support to this position by refusing to follow the *Lefkowitz* decision, although the facts presented are distinguishable on other grounds. The issue involved was the extent to which a stipulation between the government and a taxpayer in a prior criminal fraud proceeding could collaterally estop a party from denying the accuracy of the tax liability in a subsequent civil fraud proceeding. Since the *amount* of taxable income is not essential to the determination of the criminal conviction, the court held that the doctrine of collateral estoppel should not apply in any event. Moore v. United States, 235 F. Supp. 387 (W.D. Va. 1964).

31. Cirillo v. Commissioner, 314 F.2d 478 (3d Cir. 1963).

fraud committed prior to the filing of the joint delinquent income tax return, which is accurate, can be imputed to the wife. Admittedly, Section 6013(d)(3)[32] provides that liability shall be joint and several where a joint return is filed. However, in *Lefkowitz*, the fraud penalty was not imposed or measured by a deficiency founded on *filing* the joint return. The deficiency upon which the government imposed its fraud penalty was based on the husband's *failure to file* his return with an intent to evade taxes. Presumably, a wife electing to sign a joint return is liable only for the tax reported on the return including any deficiency which may be assessed in connection with the filing. It is difficult to visualize any basis upon which the wife could be subject to liability.[33] Unfortunately, the *Lefkowitz* court failed to meet the issue. The court sidestepped the problem by indicating that the plea on behalf of the wife was unsupported by any evidence that it was the wife that had made the payment of the fraud penalties with her own funds as distinguished from those of her husband. Therefore, in effect, the court contended, that she failed to demonstrate standing to recover the payments when she did not allege or prove that she had made them. By this rationale, the wife would be subject to liability for the assessment but have no remedy for refund unless she herself had made the payment.

The *Lefkowitz* decision represents an extended application of the doctrine of collateral estoppel that goes far beyond the intent announced by the court over fifty years ago.[34] Nevertheless, it is a step in the right direction. The *Lefkowitz* decision, in its approach, is harmonious with the intent of the doctrine of collateral estoppel. Unnecessary relitigation of factual issues should be avoided. Making minute and pointless distinctions in statutory verbiage is undesirable. It is untenable to deny that a conviction for willfullness to evade a tax, proved beyond a reasonable doubt, does not necessarily encompass the elements of fraud in a subsequent contest where the standard of proof is a preponderance of the evidence.[35] The differences between criminal and civil proceedings, where applicable, would be most stringently in favor of the taxpayer in the criminal action. Therefore, the taxpayer should have no cause to complain against being precluded from relitigating an issue already adjudicated in a proceeding imposing a greater burden on the government.

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32. INT. REV. CODE OF 1954, corresponding to § 51(b) of the INT. REV. CODE OF 1939.

33. *Compare* Cirillo v. Commissioner, 314 F.2d 478 (3d Cir. 1963), *with* Spanos v. United States, 212 F. Supp. 861 (D. Md. 1963).

34. Amos, 43 T.C. 50, 57 (1964).

35. There is an increasing tendency to admit a judgment of conviction into evidence in a subsequent civil suit based upon the act for which judgment of conviction was rendered. Twentieth-Century-Fox Film Corp. v. Lardner, 216 F.2d 844 (9th Cir. 1954). However, it is difficult to understand why the *Lefkowitz* court admitted the certified copy of the indictment, judgment and commitment without demanding introduction of the entire prior criminal record in order to determine, at the very least, whether there were sufficient facts contained in the record to justify a finding of willfullness. However, if objection was made at the trial court level it was not pursued and the error, if any, was not preserved.