

Spring 1971

Collateral Estoppel in Tax Fraud Litigation: The Elimination of Joint and Several Liability

Recommended Citation

Collateral Estoppel in Tax Fraud Litigation: The Elimination of Joint and Several Liability, 5 Val. U. L. Rev. 636 (1971).
Available at: <http://scholar.valpo.edu/vulr/vol5/iss3/8>

This Notes is brought to you for free and open access by the Valparaiso University Law School at ValpoScholar. It has been accepted for inclusion in Valparaiso University Law Review by an authorized administrator of ValpoScholar. For more information, please contact a ValpoScholar staff member at scholar@valpo.edu.



COLLATERAL ESTOPPEL IN TAX FRAUD LITIGATION: THE ELIMINATION OF JOINT AND SEVERAL LIABILITY

INTRODUCTION

The 1954 Internal Revenue Code includes two separate and distinct liability provisions for tax fraud. Section 7201 imposes criminal penalties for "willful" attempts to evade or defeat any federal tax.¹ Independent of the criminal penalty, section 6653(b) of the Code further imposes a civil sanction for filing fraudulent tax returns.² Under this latter section, if an underpayment of tax is due to fraud, an additional amount of fifty percent of the underpayment may be added to the original tax.³

The two separate liability provisions may be consecutively invoked for the same act of misconduct. In order to sustain a criminal conviction under section 7201, the tax deficiency must be willfully and knowingly made for the specific purpose of evading the tax due.⁴ The term fraud, as used in section 6653(b), also requires an intentional wrongdoing

1. INT. REV. CODE of 1954, § 7201 (formerly INT. REV. CODE of 1939, § 145(b), 53 Stat. 63) provides:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title 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.

Id.

2. INT. REV. CODE of 1954, § 6653(b) (formerly INT. REV. CODE of 1939, § 293(b), 53 Stat. 88) states:

If any part of an 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 50 percent of the underpayment.

Id. This section was amended by adding another sentence in Act of January 12, 1971, Pub. L. No. 91-679, § 2, 84 Stat. 2063. See note 68 *infra* and accompanying text.

3. *Id.* When the Internal Revenue Service determines that a tax return is fraudulent, a notice of deficiency and 50 percent penalty is mailed to the taxpayer. If the taxpayer wishes to challenge this determination, he has two alternatives. First, he may petition the tax court for a redetermination of the deficiency and fraud penalty. INT. REV. CODE of 1954, § 6213(a). Second, he may pay the amount, apply for a refund and, if this is denied, sue directly in the appropriate federal district court or the Court of Claims. *Flora v. United States*, 362 U.S. 145, 175-76 (1960); *England v. United States*, 164 F. Supp. 322, 323 (E.D. Ill. 1958); see also 28 U.S.C. § 1346(a)(1) (1964); Note, *Collateral Estoppel Applied to Determination of Fraud in Civil Tax Litigation—A Questionable Application*, 51 IOWA L. REV. 1028, 1032 (1966).

4. *Holland v. United States*, 348 U.S. 121, 139 (1954) (wilfulness involves specific intent); *United States v. Holovachka*, 314 F.2d 345, 357 (7th Cir. 1963); *Bloch v. United States*, 221 F.2d 786, 788 (9th Cir. 1955); *Wardlaw v. United States*, 203 F.2d 884, 885 (5th Cir. 1953). See *Spies v. United States*, 317 U.S. 492, 499-500 (1943); 10 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 55A.02 (1970).

with the specific purpose of evading the tax owed.⁵ Since there is a similarity between the specific intents necessary under section 7201 and section 6653(b), a criminal conviction is frequently followed by the Internal Revenue Service asserting the civil fraud penalty in a deficiency notice to the taxpayer.⁶

The similarity of the fraud issue in the successive criminal and civil proceedings raised the question whether collateral estoppel might constitutionally be invoked to prevent relitigation of that issue. Generally, the doctrine of collateral estoppel prevents relitigation of an identical issue which had been previously litigated by the parties in a judicial proceeding.⁷ When the Government attempted to extend the application of collateral estoppel to bind not only the convicted taxpayer but also his innocent spouse, this application became constitutionally questionable. The determination of this latter question was not entirely resolved until a recent amendment to section 6653(b) was adopted on January 12, 1971.

Prior to the passage of this amendment, the courts, in attempting to achieve an equitable result, had rejected the application of collateral estoppel against an innocent spouse and allowed her to relitigate the fraud of her partner. Although this judicial construction had accomplished a similar result as that now dictated by statute, it had exposed certain conflicts in reason. The purpose of this note is to examine the development of collateral estoppel in tax fraud litigation and to determine what effect the recent amendment will have in preventing anomalous results.

EVOLUTION OF COLLATERAL ESTOPPEL IN TAX FRAUD LITIGATION

Background

Collateral estoppel is a companion doctrine to *res judicata*. The principle of *res judicata* provides that once a final judgment has been rendered in an action, the parties to that action may not subsequently litigate anything that was or might have been litigated in the former

5. *Powell v. Granquist*, 252 F.2d 56, 60 (9th Cir. 1958); *Eagle v. Commissioner*, 242 F.2d 635, 637 (5th Cir. 1957); *Wiseley v. Commissioner*, 185 F.2d 263, 266 (6th Cir. 1950); *Mitchell v. Commissioner*, 118 F.2d 308, 310 (5th Cir. 1941). See 10 J. MERTENS, *LAW OF FEDERAL INCOME TAXATION*, § 55.10 (1970).

6. Although the specific intent for both penalties appears identical, successive criminal and civil actions do not involve double jeopardy since the purpose of § 7201 is to punish the taxpayer for misconduct, while § 6653(b) is to compensate the Government for time spent in collecting the tax. *Helvering v. Mitchell*, 303 U.S. 391, 398 (1938); *Kenny v. Commissioner*, 111 F.2d 374, 375 (5th Cir. 1940).

7. *Commissioner v. Sunnen*, 333 U.S. 591, 597 (1948); *Hyman v. Regenstein*, 258 F.2d 502, 509-11 (5th Cir. 1958).

proceeding.⁸ The principle of collateral estoppel also prevents relitigation in a subsequent proceeding after a final judgment has been reached. It is, however, more narrowly construed to prevent relitigation of only those issues which were in fact fully litigated previously.⁹

Before a taxpayer or his spouse can be collaterally estopped on the basis of a former action, three factors must coexist to meet the constitutional guarantee of due process: 1) a final judgment rendered in the former action; 2) an identical issue fully litigated in the former action; and 3) identical parties in both actions.¹⁰ In tracing the evolution of collateral estoppel as a procedural tool in tax fraud litigation since 1964, each of these factors will be examined separately.

Final Judgment Requirement

When a criminal court renders a decision in a tax evasion case, it is apparent that a final judgment in a court of competent jurisdiction has been reached. Where the subsequent proceeding is a civil action, however, the question ensues whether this final criminal judgment can be applied in the civil proceeding for the purpose of collaterally estopping the litigant.¹¹

Traditionally, collateral estoppel has not been applied in a civil action when the former judgment was a criminal conviction.¹² In such cases the doctrine has been rejected because the parties to the different actions were not identical. The courts further reasoned that the different degrees of proof and rules of procedure in the respective civil and criminal actions prevented collateral estoppel from applying.¹³

In tax fraud litigation, however, these reasons for rejecting collateral estoppel based on a prior criminal conviction are no longer an obstacle. The parties to the respective criminal and civil proceedings are identical—the same taxpayer and the Government. The fact that the degree of proof is different in the two proceedings should not limit its

8. *Commissioner v. Sunnen*, 333 U.S. 591, 597 (1948); *Tait v. Western Md. Ry.*, 289 U.S. 620, 623 (1933); *Hummel v. Equitable Life Assur. Soc'y*, 151 F.2d 994, 996 (7th Cir. 1945).

9. *Commissioner v. Sunnen*, 333 U.S. 591, 597 (1948); see *Buromin Co. v. National Aluminate Corp.*, 70 F. Supp. 214 (D. Del. 1947).

10. *Zdanok v. Glidden Co.*, 327 F.2d 944, 955 (2d Cir. 1964); *Bernhard v. Bank of America Nat'l Trust & Savings Ass'n*, 19 Cal.2d 807, 122 P.2d 892 (1942).

11. See *Vestal & Coughenour*, *Preclusion/Res Judicata Variables: Criminal Prosecutions* 19 VAND. L. REV. 683 (1966).

12. See, e.g., *United States v. Glidden Co.*, 119 F.2d 235, 245 (6th Cir. 1941); *United States v. Kwasniewski*, 91 F. Supp. 847, 851-52 (E.D. Mich. 1950); 2 A. FREEMAN, A TREATISE OF THE LAW OF JUDGMENTS, §§ 653-54 (5th ed. 1925).

13. See *Horn v. Cole*, 203 Ark. 361, 156 S.W.2d 787 (1941); *Siedman v. Siedman*, 53 R.I. 96, 164 A. 194 (1933).

applicability. The degree of proof in a criminal action is more stringent—beyond a reasonable doubt—and therefore, conclusive of an identical issue in the civil proceeding where the quantum of proof is a mere preponderance of the evidence.¹⁴ Consequently, a prior criminal conviction for tax evasion will meet the constitutional requirement of a final judgment for a civil fraud action.¹⁵

Identity of Issue Requirement

Another due process requirement of collateral estoppel is that the identical issue must have been fully litigated in a previous action. Until 1964 a prior criminal conviction for tax evasion was not determinative of the issue of fraud in a subsequent civil proceeding.¹⁶ The rationale for these rulings was that because the language of the respective statutory sections was different, the criminal and civil penalties must have been enacted for different purposes. Therefore, the conclusion was that Congress intended the criminal and civil liability sections to be essentially different in character.¹⁷ A prior criminal conviction for tax evasion was available merely as evidence of fraud in the civil proceeding.¹⁸

In 1964, however, the court in *Tomlinson v. Lefkowitz*¹⁹ ruled that a prior criminal conviction for tax evasion was applicable to estop the convicted taxpayer from denying the fraud element in a subsequent civil proceeding. The court held that the term “willfully” as used in section 7201 includes all the elements of fraud as used in section 6653(b).²⁰ In

14. In *John W. Amos*, 43 T.C. 50 (1964) the Tax Court stated:

A conviction in a criminal case, wherein the Government is held to a more stringent burden of proof, would necessarily be dispositive of the same issue in a subsequent civil case wherein the burden of proof required is considerably less.

Id. at 57; *Moore v. United States*, 360 F.2d 353 (4th Cir. 1965), *cert. denied*, 385 U.S. 1001 (1967); *Tomlinson v. Lefkowitz*, 334 F.2d 262 (5th Cir. 1964), *cert. denied*, 379 U.S. 962 (1965). See also *Emich Motors Corp. v. General Motors Corp.*, 340 U.S. 558 (1951); *Local 167, Teamsters v. United States*, 291 U.S. 293 (1934).

15. The converse, however, would not be true. A civil proceeding would not be conclusive of an issue for a subsequent criminal proceeding since the civil proceeding would not carry with it the more stringent burden of proof of the criminal action. See *Helvering v. Mitchell*, 303 U.S. 391 (1938); *Tomlinson v. Lefkowitz*, 334 F.2d 262 (5th Cir. 1964).

16. *Meyer J. Safra*, 30 T.C. 1026, 1035 (1958); *Eugene Vassallo*, 23 T.C. 656, 660 (1955); *William J. Powers, Jr.*, 31 P-H Tax Ct. Mem. 18, 26 (1962).

17. *Meyer J. Safra*, 30 T.C. 1026, 1035 (1958); *Eugene Vassallo*, 23 T.C. 656, 660 (1955); *William J. Powers, Jr.*, 31 P-H Tax Ct. Mem. 18, 26 (1962).

18. See Note, *Collateral Estoppel Applied to Determination of Fraud in Civil Tax Litigation—A Questionable Application*, 51 IOWA L. REV. 1028, 1032 (1966).

19. 334 F.2d 262 (5th Cir. 1964), *cert. denied*, 379 U.S. 962 (1965).

20. *Tomlinson v. Lefkowitz*, 334 F.2d 262, 265 (5th Cir. 1964); see *United States v. Palermo*, 259 F.2d 872 (3d Cir. 1958); *United States v. Pechenik*, 236 F.2d 844 (3d Cir. 1956); *United States v. Rosenblum*, 176 F.2d 321 (7th Cir. 1949); *Reeves v. United States*, 168 F. Supp. 720 (D. Neb. 1958); *Chanan Din Khan v. Barber*, 147 F. Supp. 771 (N.D. Cal. 1957).

reaching this conclusion, the court reasoned that the criminal penalty under section 7201 requires that the act of misconduct be committed with a specific intent of evading a tax known to be due. The fraud necessary to constitute liability for the fraud penalty of section 6653(b) similarly requires an intentional wrongdoing for the purpose of avoiding tax liability. The only real distinction between the two liability sections is that imposition of the criminal penalty requires a greater degree of illegal conduct.²¹ Therefore, since the issue of fraud in the civil proceeding is included in a determination of tax evasion in the criminal proceeding, collateral estoppel is constitutionally applicable to prevent that person from relitigating the issue of fraud.

Identity of Parties Requirement

In *Tomlinson v. Lefkowitz*²² the question whether the parties were identical was not involved since the same taxpayer who was criminally convicted was the principal party involved in the civil action.²³ Although *Lefkowitz* held that collateral estoppel of a taxpayer predicated upon his own prior criminal conviction was constitutionally permissible,²⁴ the estoppel of a spouse filing a joint tax return with a fraudulent partner added a new dimension. The question remained whether an innocent spouse could be estopped along with her partner to deny fraud in the joint return because of his prior criminal conviction.

Section 6013(d)(3) of the 1954 Internal Revenue Code provided that a husband and wife who file a joint tax return are jointly and

21. Compare § 7201 with § 6653(b), notes 11 and 12 *supra* and accompanying text. No statute or congressional report indicates that Congress intended by wording the statutes differently that a violation of one would not imply a violation of the other. By retaining the distinction for fifty years, Congress indicates its satisfaction with the wording of the statutes in their present form. Note, *Collateral Estoppel in Tax Fraud Proceedings*, 51 VA. L. REV. 1360 (1965). See *Chanan Din Khan v. Barber*, 147 F. Supp. 771 (N.D. Cal. 1957).

22. 334 F.2d 262 (5th Cir. 1964), *cert. denied*, 379 U.S. 962 (1965).

23. Although this case involved a joint tax return, the wife was not allowed to raise on appeal the question whether she could be collaterally estopped since she had not raised this matter in the lower court. The court suggested in dictum, however, that the wife should also be collaterally estopped unless she alleges and proves that the payments of the penalty were made with her funds. *Id.* at 266.

24. *Tomlinson v. Lefkowitz*, 334 F.2d 262 (5th Cir. 1964). See also *Moore v. United States*, 360 F.2d 353 (4th Cir. 1965), *cert. denied*, 385 U.S. 1001 (1967); *Amos v. Commissioner*, 43 T.C. 50 (1964), *aff'd*, 360 F.2d 358 (4th Cir. 1965) (overruled *Safra*); *Armstrong v. United States*, 354 F.2d 274 (Ct. Cl. 1965) (applied collateral estoppel in the Court of Claims); *Arctic Ice Cream Co.*, 43 T.C. 68 (1964) (extended collateral estoppel to apply when the criminal conviction was based on a guilty plea); *Thomas Worchester, Inc.*, 34 P-H Tax Ct. Mem. 1113 (1965); *Henry M. Rodney*, 53 T.C. 287 (1969); *C.B.C. Super Markets, Inc.*, 54 T.C. 882 (1970); *Dorothy Plunkett*, 39 P-H Tax Ct. Mem. 1359 (1970).

severally liable for the tax.²⁵ This joint and several liability applied to both deficiencies in tax payments and penalties arising from these deficiencies.²⁶ Since the statute imposed liability regardless of who committed the fraud, the question was solely whether it must be proven in a proceeding to which the spouse was a party or if collateral estoppel of the innocent spouse could be based on the fraudulent partner's earlier conviction.

In *Thomas Worchester, Inc.*,²⁷ the Tax Court, when confronted with this issue, stated:

Even if we were to agree with Elizabeth [the wife] that she is not collaterally estopped by the prior criminal conviction of Thomas [her husband] to deny fraud in the instant case, her liability on the fraud issue (being joint and several) would still be controlled by a finding of fraud against Thomas. In other words, it would be completely *meaningless*, where a joint return has been filed, to reach contradictory results on an issue of fraud.²⁸

Worchester, in essence, ruled that even if a wife does successfully defend the fraud allegation in the civil proceeding this determination would not be beneficial to her. Since her husband is estopped to deny the fraud, he would remain liable for the fraud penalty. Consequently, since a wife is jointly and severally liable with her husband, she would also be liable to pay the penalty.

By holding that a redetermination of the fraud issue would be meaningless, the court overlooked an essential premise concerning the doctrine of collateral estoppel. In collateral estoppel, the issue is not considered absolutely decided for all subsequent proceedings; rather, it merely estops a person from *denying* a prior adverse decision of that issue.²⁹

25. INT. REV. CODE of 1954, § 6013(d)(3) reads: "If a joint return is made . . . the liability with respect to the tax shall be joint and several." Section 6013 has been amended by Act of January 12, 1971, Pub. L. No. 91-679, § 1, 84 Stat. 2063. See note 59 *infra* and accompanying text.

26. INT. REV. CODE of 1954, § 6659(a)(2) provides, "Any reference in this title to 'tax' . . . shall be deemed to refer to additions to the tax, additional amounts, and penalties provided by this chapter." *Id.* Ginsberg v. Commissioner, 271 F.2d 511, 513 (5th Cir. 1959); Boyett v. Commissioner, 204 F.2d 205, 209 (9th Cir. 1953); Howell v. Commissioner, 175 F.2d 204 (6th Cir. 1949).

27. 34 P-H Tax Ct. Mem. 1113 (1965).

28. *Id.* at 1122 (emphasis added). This ruling has been severely criticized because it overlooks the constitutional right to a day in court and misinterprets the nature of joint and several liability. See Schneidman, *The Civil Fraud Penalty and the Innocent Spouse*, 55 A.B.A.J. 994, 996 (1969).

29. Henry M. Rodney, 53 T.C. 287, 308-09 (1969).

In *Worcester*, the court was correct in stating that a wife is jointly and severally liable for the fraud once it is proven in the civil proceeding. However, when the wife successfully defends the fraud issue through litigation, she disproves the issue of fraud for both her and her husband. Therefore, neither spouse would be liable for any civil fraud penalty.³⁰ Unfortunately, the court never reached the real question whether the wife could be estopped from denying the fraud in the same manner that her husband was estopped.

The issue was properly confronted for the first time in *Moore v. United States*.³¹ The Fourth Circuit rejected the reasoning of *Worcester* and held that an innocent wife could not be estopped by the prior criminal conviction of her husband. In *Moore*, the court reasoned:

We agree that Mrs. Moore's joint liability . . . arises not from her personal fraud, but from that of her husband, but for a finding of fraud on his part to bind her, it must be made in a proceeding to which she is a party Due process requires that she be accorded her day in court on the issue of her husband's fraud.³²

Unlike *Worcester* the court in *Moore* recognized that, although a wife is jointly liable for the fraud, it must first be proven in a proceeding in which she is a party.

The effect of the decision in *Moore* was to require the Government in the civil action to prove by clear and convincing evidence that the husband committed fraud. This was necessary even though the Government had previously proven willful tax evasion, which includes fraud,³³ beyond a reasonable doubt in his criminal conviction.

When *Moore* held that a wife could not be estopped because the parties in the successive criminal and civil proceedings were not completely identical, they overlooked an exception to the identity of parties requirement. A former judgment will bind all persons who were parties to the former proceeding *and their privies*.³⁴ Traditionally, privity has meant that two persons are in a close legal relationship to each other.³⁵

30. *Id.* See also Kathleen C. Vannaman, 54 T.C. 1011 (1970).

31. 360 F.2d 353 (4th Cir. 1965).

32. *Id.* at 358.

33. See notes 20-21 *supra* and accompanying text.

34. *E.g.*, Commissioner v. Sunnen, 333 U.S. 591 (1947); Blaffer v. Commissioner, 134 F.2d 389 (5th Cir. 1943).

35. *E.g.*, 1 A. FREEMAN, A TREATISE OF THE LAW OF JUDGMENTS, § 438 (5th ed. 1925); 1B J. MOORE, FEDERAL PRACTICE, ¶ 0.411[1] (1965); RESTATEMENT OF JUDGMENTS, §§ 83-92 (1942).

When this close legal relationship exists, the person stands in the shoes of the former litigant and may be estopped in the same manner as if he were an actual party to the former proceeding.³⁶ *Moore* did not raise the question whether a husband and wife who file a joint tax return were in privity.

In *Henry M. Rodney*,³⁷ the Tax Court was split in four separate opinions on this question of privity between a husband and wife filing a joint tax return.³⁸ The majority opinion held that neither the marital status nor the filing of joint returns by a husband and wife was sufficient to establish privity. They were separate and distinct taxpayers.³⁹ Consequently, to collaterally estop the wife because of the criminal conviction of her husband would have been a denial of her due process right to a day in court.⁴⁰ The Government must affirmatively prove the fraud by clear and convincing evidence in the civil action where the wife was a party.⁴¹

The dissent reasoned that privity is merely a short method of concluding that a person is not a stranger to a prior action. A husband and wife who file a joint return should therefore be considered a single taxable unit. The dissent based privity on a number of factors. The filing of joint returns where husband and wife combine their respective incomes in one tax return for lower tax rates was a sufficient reason to create privity.⁴² Also, the joint and several liability provisions of the Code establish a statutory privity.⁴³ Furthermore, the dissent argued that a husband and wife are in a contractual privity on a joint return by virtue of two contracts. First, when they sign the joint return, they form a bilateral contract with the Government agreeing to be jointly and severally liable in return for split-income benefits. Second, each spouse is a third party beneficiary to a contract between the other spouse and the Government establishing split-income benefits in exchange for joint and

36. *E.g.*, 1 A. FREEMAN, A TREATISE OF THE LAW OF JUDGMENTS, § 438 (5th ed. 1925); 1B J. MOORE, FEDERAL PRACTICE, ¶ 0.411[1] (1965); RESTATEMENT OF JUDGMENTS, §§ 83-92 (1942).

37. 53 T.C. 287 (1969).

38. In *Rodney*, four judges agreed with the majority; five judges concurred in result in a separate opinion, while one judge concurred in part and dissented in part and six judges dissented.

39. *Henry M. Rodney*, 53 T.C. 287, 307 (1969); *Marie A. Dolan*, 44 T.C. 420, 428 (1965).

40. This conclusion was adopted from *Moore v. United States*, 360 F.2d 353 (4th Cir. 1965).

41. *Henry M. Rodney*, 53 T.C. 287, 310-11 (1969).

42. *Id.* at 326. *See Taft v. Helvering*, 311 U.S. 195 (1940).

43. *Henry M. Rodney*, 53 T.C. 287, 325 (1969).

several liability.⁴⁴ Each of these factors, which the dissent concluded was sufficient to create privity, required the existence of joint and several liability for the fraud penalty through section 6013(d)(3).

Both concurring opinions felt the question was not privity, but rather, the extent and propriety of joint and several liability. Judge Tannenwald, concurring in result, reasoned that section 6013(d)(3) established joint and several liability only once fraud was proven.⁴⁵ Since the Code is silent on what is meant by joint and several liability, the common law rule that a joint obligor is not estopped by a judgment against another joint obligor should prevail.⁴⁶ Judge Sterrett, concurring in part and dissenting in part, argued that the inequities of imposing a quasi-criminal penalty on an innocent person through section 6013(d)(3) should be remedied.⁴⁷

In *Kathleen C. Vannaman*⁴⁸ the Tax Court reaffirmed its decision in *Rodney* that a spouse could not be estopped because of her partner's former conviction. The court, however, rejected the contention of the innocent spouse that she could not be held liable for the fraud penalty unless the Government proved that she personally committed fraud.

We reiterate that all we held in *Rodney* was that an innocent wife is entitled to rebut respondent's [the Government's] assertion of her husband's fraud. Therefore, even though Vannaman [the fraudulent partner] is estopped from denying that he committed fraud . . . Kathleen [his wife] may do so. But if the respondent affirmatively proved, by clear and convincing evidence, that Vannaman did commit fraud . . . that showing is sufficient to render Kathleen—as well as Vannaman—liable for the deficiencies and additions.⁴⁹

Since section 6013(d)(3) provided for joint and several liability once

44. *Id.* at 327. The contractual privity theory was developed in Note, *Moore v. United States*, [cite omitted] *Collateral Estoppel Applied to Wives in Civil Tax Fraud Proceedings*, 62 Nw. U.L. Rev. 108, 116 (1967).

45. Henry M. Rodney, 53 T.C. 287, 321 (1969). See *United States v. Wainer*, 211 F.2d 669, 673 (7th Cir. 1954); *Marie A. Dolan*, 44 T.C. 420, 426 (1965); *Natalie D. Du Mais*, 40 T.C. 269, 272 (1963).

46. See Note, *Moore v. United States*, [cite omitted] *Collateral Estoppel Applied to Wives in Civil Tax Fraud Proceedings*, 62 Nw. U.L. Rev. 108, 113-14 (1967).

47. Henry M. Rodney, 53 T.C. 287, 323 (1969). In *C.B.C. Super Markets, Inc.*, 54 T.C. 882 (1970), the Tax Court reaffirmed this decision on collateral estoppel of a spouse. However, *C.B.C.* added the question whether a president, manager and majority stockholder of a close corporation is in privity with the corporation itself. The majority held there was no privity, but a six judge dissent again felt that privity existed.

48. 54 T.C. 1011 (1970).

49. *Kathleen C. Vannaman*, 54 T.C. 1011, 1018 (1970).

the fraud was proven in the civil action, the Government was not required to establish that the innocent spouse was involved in the fraud in order to hold her liable for the 50 percent penalty. Both signers of a joint return were liable for the fraud penalty once it was proven that either of them had committed fraud.⁵⁰

The decisions of *Henry M. Rodney* and *Kathleen C. Vannaman* exemplify the divergent arguments concerning the question of collateral estoppel of an innocent spouse which existed before section 6653(b) of the Internal Revenue Code was amended. Although those decisions seemed to resolve the conflict, certain problems were inherent in their determinations.

INCONGRUITIES OF REJECTING COLLATERAL ESTOPPEL

The decisions of *Henry M. Rodney* and *Kathleen C. Vannaman* that an innocent spouse who filed a joint tax return with a fraudulent partner could not be collaterally estopped by the prior criminal conviction could have produced a judicial contradiction. It must be remembered that the fraudulent partner remained estopped to deny his own fraud.⁵¹ The innocent spouse could not simply establish her own innocence in the civil action, but rather, since liability was joint and several, she would have to assert an adequate defense for her partner.⁵² Conceivably, if she were successful, neither husband nor wife would be liable for the civil fraud penalty which the Government only needed to prove by clear and convincing evidence.⁵³ This, however, would not have varied the result of the prior criminal conviction. Therefore, the fraudulent spouse could possibly be serving up to a five year sentence for tax evasion while being exonerated in the civil proceeding under a lesser burden of proof.⁵⁴

Conversely, if the innocent spouse was unable to rebut the Government's contention that her partner had committed fraud, she would be liable for the 50 percent penalty even though she was not a party to the fraud and had no knowledge of her husband's misconduct.⁵⁵

The possibility that contradictory results on an identical issue might have been obtained on similar evidence tended to diminish the prestige of the judiciary.⁵⁶ More important, there was the possible inequity of

50. *Id.*

51. *Moore v. United States*, 360 F.2d 353 (5th Cir. 1964); *Kathleen C. Vannaman*, 54 T.C. 1011 (1970); *Henry M. Rodney*, 53 T.C. 287 (1969).

52. *Kathleen C. Vannaman*, 54 T.C. 1011 (1970).

53. *Id.*

54. *See Armstrong v. United States*, 354 F.2d 274, 291 (Ct. Cl. 1965).

55. *Kathleen C. Vannaman*, 54 T.C. 1011 (1970).

56. In *Armstrong v. United States*, 354 F.2d 274 (Ct. Cl. 1965), the court stated: <http://scholar.valpo.edu/vulr/vol5/iss3/8>

punishing an innocent spouse by holding her jointly liable for the quasi-criminal fraud penalty. These types of potential incongruities in the administration of the tax laws motivated Congress to amend section 6653(b) to eliminate joint liability for the fraud penalty.

ELIMINATION OF JOINT AND SEVERAL LIABILITY

In promulgating a revision of the joint and several liability provisions of the Internal Revenue Code, Congress indicated its concern over the inequities which had been inflicted upon an innocent spouse who had filed a joint return.⁵⁷ To minimize the harshness inherent in the application of joint and several liability, Congress approved a bill revising sections 6013 and 6653(b) of the Code.⁵⁸

Subsection (e) of section 6013 was enacted in order to free the innocent spouse of joint and several liability where her husband had omitted reportable income from their return. This subsection contains numerous qualifications which must be complied with in order for her to escape liability. Subsection (e) provides that a spouse filing a joint return will be relieved of liability if:

(A) a joint return has been made . . . and on such return there was omitted from gross income an amount properly includable therein . . . which is in excess of 25 percent of the amount of gross income stated in the return,

(B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission, and

(C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax. . . .⁵⁹

Since all three parts of subsection (e) must be fulfilled, its impact in

The doctrine [collateral estoppel] rests not only on the desire to avoid repetitious trials but just as firmly on the need to avoid conflicting adjudications (involving the same parties), as well as the need to put an end to controversies. *Id.* at 290-91. See *Buromin Co. v. National Aluminate Corp.*, 70 F. Supp. 214, 217 (D. Del. 1947); Vestal, *Rationale of Preclusion*, 9 ST. LOUIS U.L.J. 29 (1964).

57. See H.R. REP. No. 1734, 91st Cong., 2d Sess. (1970); S. REP. No. 1537, 91st Cong., 2d Sess. (1970).

58. Act of January 12, 1971, Pub. L. No. 91-679, §§ 1, 2, 84 Stat. 2063. See ABA Committee, *To Eliminate the 50 Percent Civil Fraud Penalty Against an Innocent Spouse*, 22 TAX LAWYER 965 (1969).

59. INT. REV. CODE of 1954, § 6013(e).

relieving the innocent spouse of joint and several liability for such deficiencies will be limited.⁶⁰ It appears that Congress intended this subsection only for the protection of a completely innocent spouse who receives no benefit from the omission in income by her partner.⁶¹ The subsection also excludes a spouse from liability only if the amount of "omitted" income is in excess of 25 percent of the gross income stated in their return. In addition, subsection (e) applies only to omissions in income and affords no relief to the innocent spouse for an illegal deduction made by her partner.⁶²

Section 6013(e), however, does afford the innocent spouse a small amount of relief from the harsh effects of joint and several liability. This protection extends not only to the underlying deficiency but also to any interest, penalties or other amounts which might otherwise attach.⁶³ Therefore, an innocent spouse who fulfills all of the requirements of subsection (e) would not be liable for the fraud penalty. If, however, an innocent spouse could not meet all of these requirements, the fraud penalty would remain applicable to her.⁶⁴

In *O. D. Cain*,⁶⁵ one of the first decisions rendered under the new subsection (e), the Tax Court ruled that the innocent spouse qualified for the relief provided by this subsection. The amount omitted from gross income was found to be in excess of 25 percent of the stated gross income on the joint return. The court also found that the innocent spouse neither knew of nor had any reason to know of the omission and did not significantly benefit from the omitted income. Therefore, she was not liable for either the deficiencies in the underpayment of the tax or the fraud penalty.⁶⁶

Although *Cain* demonstrates that an innocent spouse can be relieved of liability for the fraud penalty through qualifying under section 6013(e), Congress apparently believed that this relief was insufficient to protect an innocent spouse from the harshness of the quasi-criminal

60. Note, *Section 6013(e): Congressional Response to Joint and Several Liability and the Innocent Spouse*, 5 VAL. U.L. REV. 616 (1971); Note, *Innocent Spouse's Liability for Fraudulent Understatement of Taxable Income on Joint Returns*, 56 VA. L. REV. 1268 (1970).

61. See H.R. REP. No. 1734, 91st Cong., 2d Sess. (1970); S. REP. No. 1537, 91st Cong., 2d Sess. (1970).

62. For a detailed analysis of § 6013(e) see Note, *Section 6013(e): Congressional Response to Joint and Several Liability and the Innocent Spouse*, 5 VAL. U.L. REV. 616 (1971).

63. INT. REV. CODE OF 1954, § 6013(e).

64. *Id.* See Emory, *New Law Alleviates Innocent Spouse—Joint Return Problem on Omitted Income*, 34 J. TAXATION 154 (1971).

65. P-H TAX CT. REP. & MEM. DEC. ¶ 71,045, 40 P-H Tax Ct. Mem. 207 (1971).

66. *Id.* at 218.

fraud penalty.⁶⁷ Therefore, section 6653(b) was amended by adding the following sentence:

In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is *due to the fraud of such spouse*.⁶⁸

As originally proposed, this amendment had provided relief from the fraud penalty only if the innocent spouse established that she had no knowledge of the fraud.⁶⁹ In this form the burden of proof for the fraud had been shifted to the taxpayer. Although in the ordinary tax proceeding the burden is generally on the taxpayer, the Government must assume the burden of proof in a civil fraud proceeding.⁷⁰ Therefore, the improper shift in the normal burden of proof was corrected in the adopted form of the amendment to section 6653(b).⁷¹

The revision in section 6653(b) precludes the joint and several liability provision of section 6013(d)(3) from applying to the fraud penalty. In effect, it eliminates any liability for the fraud penalty of a spouse who files a joint return unless she is also personally guilty of the fraud.⁷² Since she is no longer jointly and severally liable for her spouse's fraudulent acts, the Government must affirmatively prove *her* fraudulent conduct either in a criminal or a civil proceeding in order for her to be liable for the 50 percent fraud penalty.⁷³ To constitute fraud, the alleged misconduct must be an intentional wrongdoing for the specific purpose of evading the tax, and mere negligence in signing the fraudulent return will not create liability for the fraud penalty.⁷⁴

67. See H.R. REP. No. 1734, 91st Cong., 2d Sess. (1970); S. REP. No. 1537, 91st Cong., 2d Sess. (1970).

68. Act of January 12, 1971, Pub. L. No. 91-679, § 2, 84 Stat. 2063 (emphasis added).

69. As originally proposed the amendment to § 6653(b) read:

In the case of a joint return under section 6013, this subsection shall not apply to a spouse who establishes that, at the time the return was made, he or she did not know, and had no reason to know, of the fraud.

H.R. 19774, 91st Cong., 2d Sess. (1970).

70. INT. REV. CODE of 1954, § 7454(a) states:

In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate.

Id. See Treas. Reg. § 301.7454-1, T.D. 6498 (1960); *Goldberg v. Commissioner*, 239 F.2d 316 (5th Cir. 1956).

71. See note 68 *supra* and accompanying text.

72. Emory, *New Law Alleviates Innocent Spouse—Joint Return Problem on Omitted Income*, 34 J. TAXATION 154 (1971).

73. *Id.*

74. See note 5 *supra* and accompanying text.

When these two revisions in the tax laws are read together, a significant change can be seen in the liability structure on a joint return. Two different standards are established to determine the liability of an innocent spouse. Section 6653(b) requires an act of misconduct by a spouse before liability attaches, while section 6013(e) may still impose liability on an innocent spouse whenever the criteria in subsection (e) are not fulfilled. Consequently, it is possible for an innocent spouse to be relieved of liability for the fraud penalty arising from her partner's fraudulent omission but remain liable for the deficiency itself.⁷⁵

While section 6013(e) may appear under these circumstances to be somewhat of an illusory relief to the innocent spouse,⁷⁶ a more onerous result could occur under these different liability standards. A spouse who qualifies under subsection (e) and is therefore excluded from liability for her partner's omission could, conceivably, be held liable for the fraud penalty on this omission. This result could occur if the wife herself has fraudulently omitted another item properly includable in the return or included a fraudulent deduction in the return. Since the 50 percent fraud penalty will attach to the entire amount of an underpayment even though only a portion of such underpayment is due to fraud,⁷⁷ the wife would also be liable for the penalty on the portion of the underpayment caused by her husband's omission. This could occur even though the wife had no knowledge of her husband's omission and is not liable for the actual deficiency in tax caused by his omission.

Although this unusual circumstance seems to violate the intention of Congress to limit liability for the fraud penalty only to that person who committed the fraud,⁷⁸ it is probable that Congress intended to afford no protection to this partially fraudulent spouse. Since this spouse is no longer completely innocent, the fraud penalty should attach in its traditional form as a sanction against any type of fraudulent conduct.

While the interplay of the different liability standards for the fraud penalty and for the deficiency may at times give inadequate protection to the innocent spouse, the elimination of the quasi-criminal fraud penalty on a completely innocent spouse is a welcomed correction of an

75. Emory, *New Law Alleviates Innocent Spouse—Joint Return Problem on Omitted Income*, 34 J. TAXATION 154 (1971).

76. See Note, *Section 6013(e): Congressional Response to Joint and Several Liability and the Innocent Spouse*, 5 VAL. U.L. REV. 616 (1971).

77. INT. REV. CODE OF 1954, § 6653(b); *Arlette Coat Co., Inc. v. Commissioner*, 14 T.C. 751 (1950); *Hirschman v. Commissioner*, 12 T.C. 1223 (1949). See *Goldberg v. Commissioner*, 239 F.2d 316 (5th Cir. 1956).

78. See H.R. REP. No. 1734, 91st Cong., 2d Sess. (1970); S. REP. No. 1537, 91st Cong., 2d Sess. (1970).

inequity in the tax laws. As a practical matter, the amendment to section 6653(b) has also eliminated the factor upon which the question of collateral estoppel of an innocent spouse had been predicated.⁷⁹

CONCLUSION

Although the injustice of holding a completely innocent spouse liable for the fraud of her partner is now alleviated by statute, it appears at first glance not to have altered the results which had been achieved by *Moore v. United States* or *Henry M. Rodney*. The end result, however, does differ in a number of important aspects. Under the present statute, an innocent wife will never be held liable for the fraud penalty unless the Government proves that she has participated in the fraudulent act. Previously, the innocent spouse would remain liable for the fraud penalty unless the Government failed to establish the fraud of her husband. Her personal innocence was immaterial in determining her liability. Under the current statute, the innocent spouse will no longer be litigating the innocence of her partner in the civil action since her liability depends solely upon her own misconduct.

Another equally significant difference is that the fraudulent partner will never be relieved of fraud liability once he has been criminally convicted. He will remain estopped to deny the fraud and cannot be relieved of liability merely because a court or a jury is sympathetic to his wife's efforts to dispel his guilt in the civil proceeding. Consequently, by not allowing relitigation of the husband's fraudulent conduct, the prestige of the judiciary through the stability of a verdict is enhanced.⁸⁰

The recent revision of section 6653(b) has therefore alleviated a perplexing problem in tax fraud litigation while achieving an equitable result. An innocent person can no longer be held liable for the fraudulent acts of another, and, conversely, a fraudulent person will no longer enjoy the potentiality of being relieved of liability because of sympathies toward his innocent partner. As a by-product of this amendment, the doctrine of collateral estoppel will no longer be advocated against an innocent spouse who files a joint income tax return.

79. See H.R. REP. NO. 1734, 91st Cong., 2d Sess. (1970); S. REP. NO. 1537, 91st Cong., 2d Sess. (1970).

80. *Armstrong v. United States*, 354 F.2d 274 (Ct. Cl. 1965).