

## TAX LITIGATION ISSUES

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### *How the IRS Recoups Unpaid Taxes in Criminal Tax Cases*

Courts are authorized to impose restitution as part of a sentence in certain criminal cases. The statutes governing restitution specify that a court may order restitution for the crimes listed in the Criminal Code (Title 18), certain narcotics violations and certain other violations involving the transportation of hazardous materials and aircraft piracy.



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#### Convicts Still to Make Restitution

While tax offenses set forth in Internal Revenue Code (IRC) are omitted from the listed crimes, those convicted of tax crimes can still find themselves obligated to make restitution to the U.S. government either as part of their criminal sentence or through a separate civil proceeding.

Although Congress did not provide for restitution in tax cases, a sentencing court "may...order restitution in any criminal case to the extent agreed to by the parties in a plea agreement."<sup>1</sup> Thus, where a defendant in a criminal tax case consents to provide restitution in a plea agreement, the court can impose an order of restitution as part of the defendant's sentence. As recently as 2003, almost 92 percent of federal tax cases were resolved through guilty pleas,<sup>2</sup> and in such cases the government may be able to negotiate a concession that the defendant will pay restitution as part of a plea agreement.

Second, a conspiracy to violate the IRC is prosecuted under §371 of the Criminal Code. Because a conviction under this statute, like all violations of the Criminal Code, subjects the defendant to an order of restitution, a defendant who is convicted of conspiracy to

commit a tax offense may face the imposition of restitution at sentencing.<sup>3</sup> For example, in *United States v. Helmsley*, Leona Helmsley was sentenced to pay more than \$1 million in restitution for federal taxes owed following her conviction of conspiracy to commit certain tax offenses. However, many tax cases do not involve conspiracies, and thus will not fall within this exception to the general rule.

Finally, the U.S. Court of Appeals for the Second Circuit has held that, notwithstanding the unavailability of restitution as a penalty in tax cases, defendants convicted of violations of the IRC may be ordered to pay restitution as a condition of their supervised release. In *United States v. Bok*,<sup>4</sup> the defendant was convicted by a jury of tax evasion and making false statements on corporate income tax returns, both violations of the IRC. Mr. Bok was sentenced to 30 months in prison and three years of supervised release. As a condition of Mr. Bok's supervised release, the sentencing court required him to pay 10 percent of his gross monthly income to the government as payment of taxes due. Mr. Bok appealed this portion of his sentence claiming that the restitution requirement violated §3663 of the Criminal Code.<sup>5</sup>

In affirming the sentence imposed, the Second Circuit examined §3583(d) of the Criminal Code which governs conditions of supervised release. Specifically, that section provides that "[t]he court may order, as a...condition of supervised release...any condition set forth as a discretionary condition of probation [identified in §3563(b)(1)-

(10)]...and any other condition it considers to be appropriate." In turn, §3563(b) includes among the discretionary conditions of probation the requirement that the defendant "make restitution to a victim of the offense."<sup>6</sup> Accordingly, the court held that a plain reading of these statutes allowed a sentencing court to impose restitution as a condition of supervised release despite the fact that it could not directly require the defendant to pay restitution in a tax case.<sup>7</sup>

Thus, despite the exclusion of IRC violations from the list of statutes giving rise to orders of restitution, in addition to incarceration and the many other collateral consequences associated with a criminal conviction, many tax defendants find themselves subject to restitution either because the government mandated that a provision for restitution be included in a plea agreement, because the defendant was also convicted of a conspiracy offense, or because the court imposed restitution as a condition of supervised release. Moreover, as recent cases from other circuit courts of appeals demonstrate, the facts underlying a criminal conviction and sentence may also give rise to a civil case in which the government seeks to recover additional deficiency amounts, interest and penalties.

#### The 'Morse' Case

In *Morse v. Commissioner of Internal Revenue Service*,<sup>8</sup> the U.S. Court of Appeals for the Eighth Circuit rejected the taxpayer's arguments that a Tax Court order requiring payment of tax deficiencies and penalties for underreported income was barred by the doctrines of res judicata, collateral estoppel and double jeopardy. In 1998, Mr. Morse was convicted of four counts of filing false personal income tax returns and sentenced to 18 months in prison and ordered to pay \$61,700 in restitution to the Internal Revenue Service (IRS), as well as a \$10,000 fine and more than \$3,000 in prosecution costs. Mr. Morse made these payments by

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September 1999; in August 2000, however, he received a notice from the IRS requiring payment of additional tax deficiencies for the same years in question in the criminal case, as well as related fraud penalties.<sup>9</sup>

Mr. Morse objected, arguing that: (1) the order in the criminal case that he pay \$61,700 in restitution precluded a finding that he owed additional deficiency amounts because the doctrines of res judicata and collateral estoppel barred relitigation of the amount of underpaid taxes; and (2) he did not owe the penalty amounts because there was no factual basis for a finding of fraud and the imposition of such amounts would violate the Double Jeopardy Clause as he already had been punished for the same conduct in the criminal case. The Tax Court rejected Mr. Morse's arguments and upheld the commissioner's determinations, but provided that Mr. Morse's restitution payments would be credited against the civil tax deficiency amount.<sup>10</sup>

The U.S. Court of Appeals for the Eight Circuit affirmed the Tax Court's decision. After dismissing Mr. Morse's contention that there was no factual basis for a finding of fraud, the court concluded that the doctrine of res judicata did not preclude the government from seeking additional deficiencies because a criminal prosecution for filing false tax returns does not involve the same "cause of action" as a civil tax case. "The government may have both a civil and a criminal cause of action as a result of a single factual situation," and thus the government does not surrender its right to seek civil fraud penalties by undertaking a criminal tax prosecution." Furthermore, the court held that Mr. Morse's collateral estoppel argument also failed because the order of restitution was not "an element of the crime of conviction," and could, therefore, be litigated by the government in the subsequent civil case.<sup>11</sup>

## Double Jeopardy Clause

The court then addressed Mr. Morse's claim that the imposition of civil penalties violated the Double Jeopardy Clause. In rejecting this argument, the court noted that the clause's protection was against multiple criminal penalties. Stating that civil fraud penalties imposed under the IRC have long been viewed as remedial, rather than punitive in nature, the court found that the civil penalties were not barred under the Constitution and properly could be imposed.<sup>12</sup>

In *Creel v. Commissioner of Internal Revenue*, the Eleventh Circuit agreed that the government's recovery of "restitution" in a criminal case does not bar it from seeking additional money in a tax deficiency proceeding.<sup>13</sup> The court, however, placed a

potentially significant limit on the government's ability to chase criminal defendants for back taxes, interest and penalties beyond amounts paid as restitution. In *Creel*, the taxpayer pleaded guilty to willful failure to file federal income tax returns. As part of his plea agreement, Mr. Creel agreed to make full restitution in the amount of \$83,830 plus any interest and penalties imposed by the IRS. The district judge incorporated this into the sentence, ordering Mr. Creel to make restitution "in the amount of '\$83,830 plus any applicable penalties and interest'" as a condition of his probation.<sup>14</sup>

From May 1994 through June 1998, Mr. Creel made monthly restitution payments

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*'Morse' and 'Creel' both let the government seek added tax deficiencies, penalties and interest in a civil proceeding despite prior restitution being paid in a criminal case.*

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totaling \$83,830. Upon making the final payment, he was informed that his restitution obligation had been satisfied and the United States Attorney filed a Satisfaction of Judgment and Cancellation and Release, fully releasing Mr. Creel and noting that the debt was "paid in full." The IRS, however, applied the restitution payments to Mr. Creel's tax, interest, and penalty obligations for only two of the years in question, and, in 2000, instituted a civil action seeking over \$200,000 in taxes, interest, and penalties for the years covered by the criminal prosecution, as well as another year. The matter ultimately was taken before the Tax Court, which found that Mr. Creel's payment of \$83,830 and the U.S. attorney's issuance of a release and satisfaction of judgment served to settle any alleged civil liabilities for the years covered by the criminal case.<sup>15</sup>

## In the Eleventh Circuit

Reviewing the decision, the Eleventh Circuit agreed with the government's position that it was entitled to seek civil penalties despite Mr. Creel's payment of his criminal restitution obligation, noting that the criminal restitution statute specifically contemplates subsequent civil actions by providing that amounts paid in the criminal case would be offset against any damages recovered in the civil proceeding. The court observed, however, that "[t]he key problem

with the Commissioner's position is that it fails to take into account the unique facts and the nuances of the instant case, most notably the language of the restitution judgment and the actions of the U.S. Attorney." The court stated that the language of the satisfaction of judgment and cancellation and release executed by the U.S. attorney upon Mr. Creel's payment of the \$83,830 served to discharge Mr. Creel's criminal and civil liability because the restitution order specifically included penalties and interest—the same penalties and interest the commissioner now sought to recover. Because the U.S. attorney had the authority to resolve both criminal and civil liabilities, all claims against Mr. Creel were extinguished by the filing of those documents and, accordingly, Mr. Creel was not obligated to pay further penalties or interests.<sup>16</sup>

## Conclusion

Although the result may have been different, *Morse* and *Creel* both permitted the government to seek additional tax deficiencies, penalties and interest in a civil proceeding despite the fact that the taxpayer had been ordered to pay restitution in a criminal case based on the same underlying facts. While restitution amounts paid in a criminal case may be deducted from amounts found owing in a civil action, a taxpayer should not assume that satisfaction of the terms of a restitution order in a criminal case discharges all liability to the IRS.

1. 18 USC §3663(a)(3).

2. See 2003 Sourcebook of Federal Sentencing Statistics, United States Sentencing Commission, Table 11 (available at <http://www.ussc.gov/ANNRPT/2003/table11.pdf>)

3. Section 3663 includes all offenses listed under Title 18 among the crimes pursuant to which a court can impose restitution.

4. 156 F3d 157 (2d Cir. 1998). One of the authors represented the government in this case.

5. *Id.* at 159-160.

6. See §3563(b)(2).

7. 156 F3d at 166-167.

8. 419 F3d 829 (8th Cir. 2005).

9. *Id.* at 831-832.

10. *Id.* at 834, n.4 (citing Tax Court's opinion, 2003 WL 22853796 (Tax Ct. Dec. 3, 2003)).

11. *Id.* at 834.

12. *Id.* at 834-845.

13. 419 F3d 1135 (11th Cir. 2005).

14. *Id.* at 1137-1138.

15. *Id.* at 1139.

16. *Id.* at 1140-1141.

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