



Tax Claims Against Embezzlers, Swindlers, Etc. v. Recovery By
Investors, Dupes and Victims

Cases involving a competition between tax claims owed by wrongdoers, such as embezzlers, swindlers, and fraudsters, on the one hand, and investors, dupes and victims of the wrongdoing, on the other, against a fund or other property¹ present some unique considerations and litigation hazards. In order to evaluate those hazards, a Trial Attorney needs to answer the following questions:

1. *Do the Claims of the IRS and the Investors and Victims Arise from the Same Transaction?*
2. *Can the Investors or Victims Trace Their Property to the Fund?*
3. *Is There a Federal Restitution Lien And, If So, Does it Have Priority over the Federal Tax Lien?*
4. *What Impact, If Any, Does the Justice for All Act of 2004 Have on a Particular Case?*
5. *Does a Federal Tax Claim Have Priority over Claims by Creditors Other than Investors or Victims?*
6. *How Should Taxes Incurred as Part of the Administration of an Estate or Property be Treated?*

¹ As used here, “investor” denotes a willing participant or customer who was misled or defrauded by the perpetrator (see *Cunningham v. Brown*, 265 U.S. 1, 7 (1924)). “Victim” denotes a person who did not willingly participate or willingly part with money or property, such as when there is theft, including embezzlement.

Discussion

In general, in accordance with Tax Division Directive 137, the United States will cede its federal tax claim to the victim's claim when two requirements are met. First, the tax claim and the victim's claim arise from the same transaction. Second, the funds or property are traceable to the fraud or wrongdoing.

1. *Do the Claims of the IRS and the Investors or Victims Arise from the Same Transaction?*

The origin of the claims is an important factor in analyzing the relative priority of the competing claims. Claims for unpaid taxes may arise from the same or separate conduct as the wrongdoing which gave rise to the claim of the victim. When the taxes and victims' claims arise from the same transaction or activity, the United States has increased litigation hazards. In such cases, taxes are imposed on the wrongdoer-taxpayer for income wrongfully obtained from the victim, and we are in the awkward position of asserting that the victim cannot get relief because, as a result of the same wrongdoing, the wrongdoer-taxpayer now owes taxes that would not have been owed but for the wrongdoing.

a. *Origin of Tax Claim.*

A wrongdoer-taxpayer must include in gross income funds wrongfully obtained by embezzlement, swindle, or other deceit, even when a crime victim has "a right to recoupment" against the funds or other property wrongfully taken. *James v. United States*, 366 U.S. 213, 216-217 (1961). A wrongdoer-taxpayer obtaining funds through such wrongdoing likely will not report the income on a federal tax return. Consequently, the IRS may first learn of the omitted income when the wrongdoing is uncovered and reported on by the press.

Claims for unpaid taxes may also arise independently from the wrongdoing. For example, the taxpayer may have failed to report other income, claimed erroneous deductions, or have employment or excise tax liabilities. Courts may be hostile to these claims to the extent the claims diminish the victims' recovery or a receiver's compensation.

In addition, the IRS may make an administrative claim in a receivership for taxes on gain recognized upon the sale of assets or on income from the investment of receivership property. *See, e.g., S.E.C. v. Credit Bancorp. Ltd.*, 297 F.3d 127 (2d Cir. 2002). If a receiver hires employees to administer the property, there may also be employment tax liabilities. These claims are expenses of administration. Like all other expenses of administration, these claims should be paid before there is any distribution to victims or creditors. Again, courts may be hostile to a tax claim to the extent it reduces the recovery of others.

b. Origin of Investor's or Victim's Claim.

In some cases, such as embezzlement, the victim's property is stolen and title does not pass to the wrongdoer. When the case involves a complete failure to pass title, such as a theft, the victim has the superior claim to traceable property. In other cases, a person voluntarily parts with property due to fraud or misrepresentation and title passes to the wrongdoer. When someone voluntarily parts with property due to fraud or misrepresentation, a court may impose a constructive trust, deeming the wrongdoer to hold bare legal title for the benefit of the person duped.

2. Can the Investors or Victims Trace Their Property to the Fund?

When a victim can trace stolen property into the assets in a case, the victim's claim will have priority because title never passed to the wrongdoer. When an investor or dupe can trace property lost through fraud into the fund or property subject to competing claims, absent statutory liens, the investor's claims have priority because the court has or would impose a constructive trust on behalf of the duped investor.

In order to prevail, however, an investor or victim must trace his assets to the property held in constructive trust or receivership. *United States v. Schwimmer*, 968 F.2d 1570, 1583-1584 (2d Cir. 1992) ("The beneficiary of a constructive trust does not have an interest superior to the trustee's in every asset the trustee holds, but only in those assets held in constructive trust or

traceable to such assets.”); *Rosenberg v. Collins*, 624 F.2d 659, 663 (5th Cir. 1980) (“A constructive trust, however, can only attach to some identifiable property which can be traced back to the original property acquired by fraud.”); see also, *Cunningham v. Brown*, 265 U.S. 1, 11-12 (1924) (absent the ability to trace, “the defrauded lender becomes merely a creditor to the extent of his loss”). When the wrongdoer has commingled the assets obtained from the investor or victim with other assets, tracing may be difficult. *United States v. Peoples Benefit Life Ins. Co.*, 271 F.3d 411, 416 (2d Cir. 2001) (property at issue “not readily identify[able]. . . or traceable;” claim of embezzlement victim held too remote to funds in issue). In response to the sometimes harsh results which follow when tracing is not possible, some courts have adopted less stringent tracing requirements. *United States v. Benitez*, 779 F.2d 135, 139 (2d Cir. 1985) (relaxed tracing requirement when wrongdoer acquiesces in forfeiture of assets as fruit of a crime).

3. *Is There a Federal Restitution Lien And, If So, Does it Have Priority over the Federal Tax Lien?*

A federal court, pursuant to 18 U.S.C. § 3663A, may include as part of a criminal sentence an order for restitution. A restitution order gives rise to a statutory lien. The restitution lien arises when the order of restitution is entered. The restitution lien, like a tax lien, attaches to all property and rights to property of the criminal defendant. Like a tax lien, notice of the restitution lien must be filed before it will receive priority as to certain creditors.²

² Although the statute states that the lien is “in favor of the United States,” the lien is for the benefit of the victim or defrauded investor. In addition to other remedies, such as a claim in a forfeiture proceeding, the investor or victim is also permitted to enforce the lien as a judgment lien creditor under state law. See 18 U.S.C. § 3664(m)(1)(B), which states:

At the request of a victim named in a restitution order, the clerk of the court shall issue an abstract of judgment certifying that a judgment has been entered in favor of such victim in the amount specified in the restitution order. Upon registering, recording, docketing, or indexing such abstract in accordance with the rules and requirements relating to judgments of the court of the State where the district court is located, the abstract of judgment shall

As relevant here, 18 U.S.C. § 3613 provides –

(c) Lien.--A fine imposed pursuant to the provisions of subchapter C of chapter 227 of this title, or an order of restitution made pursuant to sections 2248, 2259, 2264, 2327, 3663, 3663A, or 3664 of this title, is a lien in favor of the United States on all property and rights to property of the person fined as if the liability of the person fined were a liability for a tax assessed under the Internal Revenue Code of 1986. The lien arises on the entry of judgment and continues for 20 years or until the liability is satisfied, remitted, set aside, or is terminated under subsection (b).

(d) Effect of filing notice of lien.--Upon filing of a notice of lien in the manner in which a notice of tax lien would be filed under section 6323(f)(1) and (2) of the Internal Revenue Code of 1986, the lien shall be valid against any purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor, except with respect to properties or transactions specified in subsection (b), (c), or (d) of section 6323 of the Internal Revenue Code of 1986 for which a notice of tax lien properly filed on the same date would not be valid. The notice of lien shall be considered a notice of lien for taxes payable to the United States for the purpose of any State or local law providing for the filing of a notice of a tax lien. A notice of lien that is registered, recorded, docketed, or indexed in accordance with the rules and requirements relating to judgments of the courts of the State where the notice of lien is registered, recorded, docketed, or indexed shall be considered for all purposes as the filing prescribed by this section. The

Footnote continued. . .

be a lien on the property of the defendant located in such State in the same manner and to the same extent and under the same conditions as a judgment of a court of general jurisdiction in that State.

provisions of section 3201(e) of chapter 176 of title 28 shall apply to liens filed as prescribed by this section.

When priority is asserted under a restitution lien, there is no tracing requirement and the lien extends to all property of the wrongdoer regardless of whether the property was acquired wrongfully. The relative priority of the federal restitution lien and the federal tax lien is determined under the age-old rule that “first in time is first in right.” See *United States v. Vermont*, 377 U.S. 351 (1964).

Assessment and restitution liens arising prior to disgorgement or turnover of property to a receiver attach to and follow the property into the receivership. *S.E.C. v. Levine*, 881 F.2d 1165, 1177 (2d Cir. 1989). The lien arising first, comparing the date of assessment to the date of the restitution order, has priority.

These statutory liens do not attach, however, to property transferred to a receiver or subject to a court-ordered constructive trust before assessment or the order of restitution. A constructive trust is a judicial remedy and arises upon the court decree establishing the constructive trust. *Blachy v. Butcher*, 221 F.3d 896, 905 (6th Cir. 2000). “Even if [State] law allows the doctrine of ‘relation back’ to give the beneficiary of a constructive trust priority over private intervening interests, this would not be determinative as to the IRS. The priority of a federal tax lien against competing claims is governed by federal law.” *Id.* Consequently, it is important to determine when the constructive trust arose *vis-a-vis* the statutory liens in order to analyze the competing claims, and identify the property subject to the trust to which an investor or victim can trace his loss. Of course, as stated above, if title to property never passed to the wrongdoer, such as with stolen property, the federal tax lien will not attach in the first instance. *Dennis v. United States*, 372 F. Supp. 563 (E.D. Va. 1974).

4. *What Impact, If Any, Does the Justice for All Act of 2004 Have on a Particular Case?*

The *Justice for All Act of 2004*, 18 U.S.C. § 3771, in the same spirit as the Tax Division’s longstanding policy, provides, as is relevant here, that a

crime victim (which would include victims of theft, as well as defrauded investors) has “(a)(6) the right to full and timely restitution as provided in law.”

The *Justice for All Act* instructs that Department of Justice attorneys “engaged in the detection, investigation, or prosecution of crime shall make their best efforts to see that crime victims are notified of, and accorded, the rights described in subsection (a).” The Attorney General has promulgated regulations, 45 C.F.R. § 45.10(a), which define an Employee of the Department of Justice as:

[A]n attorney, investigator, law enforcement officer, or other personnel employed by any division or office of the Department of Justice whose regular course of duties includes direct interaction with crime victims, not including a contractor.

Attorneys and paralegals, as well as support personnel, in the Civil Trial and Appellate Sections, and the Office of Review, do not have within their regular course of duties interaction with crime victims. Accordingly, the statutory obligation to use their best efforts to see that crime victims are accorded their rights under the Justice for All Act of 2004 (along with the potential disciplinary action for failure to use best efforts in such a manner), ordinarily does not apply to the Tax Division’s civil attorneys.³

The Tax Division’s policy promotes the same ends as the *Justice for All Act of 2004* by directing that, when statutory liens are not involved, the restitution claims of defrauded investors and crime victims are given priority over claims for the wrongdoer’s unpaid federal taxes so long as either (1) the victim of a theft can trace a claim to the property since, by virtue of the theft, title has not passed, or (2) the defrauded investor can show that his claim and the tax claim arise from the same transaction and the investor can trace his

³ It is important, however, to be mindful that some Assistant United States Attorneys and persons in their offices, as well as some higher-level officials in the Department and persons in their offices, may be subject to these provisions.

assets to the property. When statutory liens are involved, the relative priority is determined under the well-established legal principle of “first in time is first in right,” which also satisfies the *Justice for All Act of 2004*, since application of this principle satisfies the requirement of providing “restitution as provided in law.”

5. *Does a Federal Tax Claim Have Priority over Claims by Creditors Other than Investors or Victims?*

The policy to cede a claim for unpaid taxes to a defrauded investor or victim who can trace his property to the property before the court does not extend to other creditors of the wrongdoer. When a receiver intends to pay creditors other than a defrauded investor or victim, the federal tax claim should be paid before junior creditors are paid. The priority of the federal tax claim should be determined in accordance with 26 U.S.C. § 6321, *et seq.* and case law. Thus, for example, a claim of a secured creditor (including purchase money security interests) will have priority over a later-filed federal tax lien. *United States v. Estate of Romani*, 523 U.S. 517 (1998). In some limited circumstances, the United States may be able to establish the priority of federal tax claims under 31 U.S.C. § 3713; for example, when the wrongdoer is insolvent and no claimant has a claim protected by 26 U.S.C. § 6323. *Id.*

6. *How Should Taxes Incurred as Part of the Administration of an Estate or Property be Treated?*

Taxes which are incurred as part of the administration of a receivership, such as taxes imposed on gain from the sale of property or imposed on interest earned on a bank account, should be paid in the ordinary course of business “on or before the due date of the tax.” 28 U.S.C. § 960(b)(1); *see also* 26 U.S.C. § 6012(b)(3). As part of the administration of a receivership, a receiver should set aside sufficient funds to pay any taxes due on income of the receivership. Other alternatives to obtain a determination of tax liability during administration of the receivership may be available to the receiver as well. *See S.E.C. v. Credit Bancorp. Ltd.*, 297 F.3d at 139-140. When a receiver fails to pay those taxes, the tax should come, first, from the receiver’s compensation, not the victim’s recovery.

All administrative expenses, including taxes, should be paid in full when a receivership is solvent. Administrative expenses generally are paid *pro rata* when a receivership is insolvent, which occurs when the administrative debts of the receivership exceed its assets. When a receivership is insolvent, the United States may have grounds to assert that its administrative claims must be paid first and in full before other claims are paid. See 31 U.S.C. § 3713 (in such a case, the relevant “debtor” under 31 U.S.C. § 3713(a) is the “receivership estate.”).