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UNITED STATES TAX COURT
WASHINGTON, DC 20217

MARK H. SWARTZ & KAREN M. SWARTZ,	)	
	)	
Petitioner(s),	)	
	)	
v.	)	Docket No. 3583-10.
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent	)	
	)	
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	)	
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O R D E R

This case was originally on the Court's November 14, 2011 trial calendar for Buffalo, NY and arises from Mr. Swartz's employment with Tyco. The case was for a long time on a status-report track while Mr. Swartz served out a criminal sentence, and then while the parties thought they might settle. The Commissioner eventually moved for partial summary judgment, and he argues that Mr. Swartz's criminal conviction by New York State estops him from arguing that he did not receive taxable income in the amount that he was convicted of stealing.

Background

Mr. Swartz[1] has been a CPA for many years, but in 1991 left his accounting firm to work for Tyco International Ltd.[2] as an assistant comptroller at its executive offices in New

[1] Swartz's wife, Karen Swartz, is also a petitioner in this case. The Commissioner does not seek to collaterally estop Mrs. Swartz, but asserts that she is jointly and severally liable because she filed a joint return. The issue of whether the $12.5 million loan reduction created income for Mrs. Swartz could still be litigated under I.R.C. section 6015.

[2] Tyco International Ltd. is a large and diversified manufacturing and service company. It designs, manufactures, and installs undersea cable-communication systems, conducts auto-redistribution services, maintains electronic security systems, and distributes flow-control products. During the year at issue, Tyco did quite well: It had combined net sales of $22.5 billion, assets of $32.4 billion and employed almost 200,000 people worldwide.

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Hampshire. His responsibilities there included the preparation of financial statements, and cash-flow and earnings forecasts. After four years with the company, he was promoted to Chief Financial Officer and reported directly to Tyco's Chief Executive Officer, Dennis Kozlowski.

Tyco maintained a Key Employee Loan Program (KELP) for its executive officers -- Mr. Swartz participated in the program for many years, including the 1999 tax year at issue. In August 1999, a handwritten journal entry in Tyco's accounting records mysteriously reduced Mr. Swartz's outstanding loan balance by $12.5 million. Swartz did not make any payments on this loan to Tyco during the year at issue. He also did not include the $12.5 million on his Form 1040 (for example, as cancellation-of-debt income), and Tyco did not include the amount on Mr. Swartz's W-2.

In 2001, Mr. Swartz become a member of Tyco's board of directors. Not too long afterward, the directors learned that Kozlowski was the target of a criminal investigation for possible state sales-tax violations by the district attorney in Manhattan. Kozlowski was indicted only a few days after this information surfaced and promptly resigned from the board. His replacement -- John Fort -- immediately retained a law firm to undertake a full and complete investigation of Tyco's business including compensation and transactions between Tyco and its officers and directors. This led to a conversation (the details of which are unknown on this motion) between the law firm and Swartz about the mysterious 1999 journal entry. And the conversation led to the reversal of the journal entry. Mr. Swartz then repaid the money with interest.

Within two months, Mr. Swartz found himself side-by-side with Mr. Kozlowski as defendants named in a multiple-count criminal indictment. Their first trial led to a hung jury, but a second began in 2005. The indictment charged Mr. Swartz with:

- twelve counts of grand larceny in the first degree;
- nine counts of falsifying business records in the first degree;
- one count of conspiracy in the fourth degree; and
- one count of violating New York General Business Law section 352-c(5).

The second jury found Mr. Swartz guilty on all counts except one involving falsifying business records (and not the business record of the purported loan forgiveness). The relevant counts here are counts two and fourteen. Count two alleged that Mr. Swartz "in or about August 1999 and thereafter, stole property, to wit, money, having a value in excess of $1 million, to wit, $12,500,000 from Tyco International Ltd." Count fourteen alleged that Mr. Swartz, during the year at issue, "with intent that conduct constituting the felonies of Grand Larceny in the First Degree, Grand Larceny in the Second Degree, Criminal Possession of Stolen Property in the First Degree and Criminal Possession of Stolen Property in the Second Degree be performed, agreed with each other and with others known and unknown to the Grand Jury to engage in and cause the performance of such conduct . . . ." Mr. Swartz's defense at trial was that he thought the $12.5 million loan reduction was part of his bonus, but the jury found that it was not

authorized by Tyco and that Swartz knew that. Swartz was sentenced to serve between 8 1/3 years and 25 years in prison and ordered to pay a fine of $35 million plus restitution. He has since exhausted any appeals and the judgments of conviction are final.

Discussion

We may grant summary judgment when there is no genuine dispute of any material fact and a party is entitled to judgment as a matter of law. T.C. Rule 121(b); *Sundstrand Corp. v. Commissioner*, 98 T.C. 518, 520 (1992), *aff'd*, 17 F.3d 965 (7th Cir. 1994). After the moving party submits a proper summary-judgment motion, the nonmoving party cannot rest on allegations or denials in his pleadings, but must present specific facts showing that there is a genuine issue for trial. T.C. Rule 121(d); *Dahlstrom v. Commissioner*, 85 T.C. 812, 820-21 (1985). However, the moving party still bears the burden of proving there is no genuine dispute of material fact, and we read factual inferences in a manner most favorable to the nonmoving party. *Id.*

The Commissioner argues that Mr. Swartz's conviction for stealing $12.5 million from Tyco in 1999 collaterally estops him from arguing that he did not have $12.5 million in unreported taxable income for that year.[3] Mr. Swartz asserts however, that the issues here are different than those during his trial because in 2002 Tyco adjusted its records to reflect a $12.5 million repayment obligation and then Mr. Swartz paid it. He argues that this shows the alteration of Tyco's records back in 1999 was null and void -- void *ab initio* as the Latinists would say. He argues that he didn't raise this issue in his criminal trial and that void transactions, like erasing and then restoring the record of a debt in the corporate books, does not create taxable income.

Collateral estoppel precludes a party in one case from relitigating in a later case issues of fact and law that were decided in the first. *United States v. Mendoza*, 464 U.S. 154, 158 (1984). The doctrine applies when

> an issue of law or fact in the second case is the same as one in the first case;
>
> there has been a final judgment in the first case;
>
> the party to be precluded is the same or in privity with a party in the first case;
>
> the issue that is precluded was actually litigated in the first case; and
>
> the controlling facts and legal principles are unchanged.

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[3] We've long held that proceeds from crime are gross income. I.R.C. § 61(a); *James v. United States*, 366 U.S. 213 (1961).

Peck v. Commissioner, 90 T.C. 162, 166-67 (1988). We also consider whether "special circumstances" exist. *Brotman v. Commissioner*, 105 T.C. 141, 148 n.6 (1995). In a case like this one -- where the parties in the second case are not identical -- federal law directs us to state law to see if nonmutual collateral estoppel exists. New York says it is, *see Schwartz v. Pub. Adm'r of Bronx Cty.*, 246 N.E.2d 725, 728 (N.Y. 1969), and that's good enough for us.

Mr. Swartz concedes that the Commissioner has shown that several of the requirements for collateral estoppel exist. He argues, however, that the elements of issue identity and actual litigation are not, because he never presented his "null and void" theory in the criminal case.

The first problem with this is that a party's failure to make an argument about an issue in the first case doesn't mean that he gets a do-over in the second. As the Restatement (Second) of Judgments, § 27 cmt. c (Am. Law Inst. 1982), concisely summarizes "if the party against whom preclusion is sought did in fact litigate an issue of ultimate fact and suffered an adverse determination, new evidentiary facts may not be brought forward to obtain a different determination of that ultimate fact. . . . And similarly if the issue was one of law, new arguments may not be presented to obtain a different determination of that issue."

We recognize the Mr. Swartz *may* be arguing a subtler point -- that, although his distinction between a void theft and a voidable one might not have mattered as a matter of New York criminal law, it should matter under federal income tax law. But if this is the argument he's making, it fails as a matter of law. In the landmark case in this field, the Supreme Court reasoned that

> it is inconsequential that an embezzler may lack title to the sums he appropriates while an extortionist may gain a voidable title. Questions of federal income taxation are not determined by such "attenuated subtleties."

James, 366 U.S. at 216.

There is simply a general rule that ill-gotten income -- whether through embezzlement, larceny, false pretenses, extortion, or any other species of theft -- is taxable income. In the past, we've entertained the idea that an exception to this general rule exists if a taxpayer *in the year of his theft* reaches an agreement with his victim to repay what he took. *See, e.g.*, *Buff v. Commissioner*, 58 T.C. 224, 231-32 (1972), *rev'd* 496 F.2d 847 (finding that the taxpayer's agreement to repay was not *bona fide*); *Fox v. Commissioner*, 61 T.C. 704, 713 (1974). But that's not the case here. Mr. Swartz didn't have any agreement with Tyco in 1999 to pay back what he took -- he only paid back the company in 2002 after he was caught.

So the one exception to the general rule cited to us doesn't apply. Mr. Swartz's criminal convictions in New York state collaterally estop him from denying that he embezzled funds from Tyco. *Meier v. Commissioner*, 91 T.C. 273, 293 (1988); *Romer v. Commissioner*, 71 T.C.M. (CCH) 3202 (1996). Because that amount was specific in the indictment and the jury instructions, we find he is also collaterally estopped from denying that he embezzled the specific

amount of $12.5 million from Tyco.[4] *See Johnson v. Commissioner*, 65 T.C.M. (CCH) 2760 (1993). We do note however, that the tax consequences of Mr. Swartz's repayment of the embezzled funds in 2002 are not before us here. *See generally Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990), *rev'g*, 93 T.C. 108 (1989).

It is therefore

ORDERED that respondent's motion for partial summary judgment is granted. It is also

ORDERED that on or before December 19, 2016 the parties submit settlement documents or file a status report describing their progress toward settlement or trial preparation.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
October 14, 2016

[4] This is in contrast to cases were we found that the amount of embezzled funds was not a necessary element of the taxpayer's conviction. *See Uscinski v. Commissioner*, 92 T.C.M. (CCH) 285 (2006); *Romer v. Commissioner*, 71 T.C.M. (CCH) 3202 (1996) (neither indictment nor judgment of conviction charged the taxpayer of having embezzled a specific amount); *Wheadon v. Commissioner*, 64 T.C.M. (CCH) 1172 (1992) (embezzlement convictions only required proof that the value of the thing embezzled was over $100).