



TAX LITIGATION ISSUES

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'Boulware': High Bar Set for Criminal Tax Prosecutions

In a tax evasion prosecution, the government must establish three elements: (1) that the defendant attempted to evade or defeat a tax imposed under the Internal Revenue Code; (2) that there was an additional tax due and owing (a deficiency); and (3) that the defendant acted willfully.

Over the years, the element of willfulness has been hotly litigated and a refuge for defendants charged with tax evasion.

Earlier this month, however, the U.S. Supreme Court reversed a conviction in *Boulware v. United States*,¹ holding that the government had failed to establish the existence of a tax deficiency. In *Boulware*, Justice David Souter, writing for a unanimous court, resolved a split among the circuit courts of appeals regarding under what circumstances distributions from closely held corporations can serve as the predicate of an income tax evasion prosecution. Stressing that "tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than...the particular form the parties employed,'"² the Court held that a defendant could not be convicted of tax evasion absent evidence of an actual deficiency.

Treatment of Corporate Distributions

The treatment of corporate distributions is addressed in 26 U.S.C. §301(c), which incorporates the definition of dividends set forth in 26 U.S.C. §316(a). Under these provisions, any distribution made out of earnings and profits is a dividend, which must be included in gross income.³ By contrast, where a corporation does not have earnings and profits, distributions are applied against, and reduce,



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the shareholder's basis in his or her stock.⁴ After the shareholder's basis has been exhausted, all further distributions are treated as gains from the sale or exchange of property.⁵ Reading these statutory provisions together, the U.S. Court of Appeals for the Second Circuit has held that "in the absence of earnings or profits, a shareholder may treat any distribution up to the value of capital invested in the corporation, that is, the taxpayer's basis, as a return of that capital."⁶ Moreover, in the Second Circuit, a defendant relying on the "no earnings and profits, no income" rule bears the burden of production, under which he must make an initial showing on each key element of the theory.⁷

By contrast, in *United States v. Miller*,⁸ the Ninth Circuit held that in a criminal tax evasion case, a defendant can only rely on a return of capital defense if he is able to show that, at the time the payments were made by the corporation, there was a contemporaneous intent that the payments in fact be a return of capital. Thus, rather than focusing on whether the corporation had earnings and profits, the Ninth Circuit looks to the defendant's intent at the time he received the distributions.

The 'Boulware' Proceedings

In *Boulware*, the defendant was the founder, president and majority shareholder of a closely held corporation, Hawaiian Isles Enterprises (HIE). In 2001, *Boulware* was indicted on several counts of tax evasion and filing false returns for allegedly failing to report and pay taxes on approximately \$10 million in funds he had diverted from HIE, giving millions of dollars to his girlfriend and millions more to his wife. None of the distributions were

reported on Boulware's income tax returns.

At trial, Boulware sought to argue that the funds he diverted were a return of capital he had invested in the corporation and, therefore, were not income. The government moved in limine to bar Boulware from presenting evidence supporting this return of capital theory, asserting that he could not meet his burden, under *Miller*, of making some demonstration that the distribution was intended to be a return of capital. The district court granted the government's motion and declined to instruct the jury on the defendant's return of capital theory. Boulware was found guilty of four counts of tax evasion and five counts of filing false returns.

In affirming Boulware's conviction, the Ninth Circuit noted that no contemporaneous intent requirement was imposed in civil tax cases addressing the issue of whether funds from a corporation are a return of capital. The court acknowledged that "imposing an intent requirement creates a disconnect between civil and criminal liability," but thought that under *Miller*, "the characterization of diverted corporate funds for civil tax purposes does not dictate their characterization for purposes of a criminal tax evasion charge."⁹ In a concurring opinion, Circuit Court Judge Sidney R. Thomas noted that although the panel was bound by *Miller*, its holding illogically meant that "a defendant may be criminally sanctioned for tax evasion without owing a penny in taxes to the government."¹⁰

The Supreme Court's Decision

The Supreme Court granted certiorari to answer the question of "[w]hether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholder's stock basis...even if the diversion was not intended as a return of capital."¹¹

After reviewing the statutory provisions applicable to the tax treatment of monies distributed by corporations (i.e., §§301 and 316(a) of the Internal Revenue Code), the Court concluded that if a distribution is not made out of a corporation's earnings or profits, it is not a dividend. As such, it should be treated either as a nontaxable return of capital, to the extent of the shareholder's basis in his stock, or thereafter as a gain on the sale or exchange

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