New York Law Journal

Web address: http://www.nylj.com

VOLUME 239—NO. 54 THURSDAY, MARCH 20, 2008 ALM

TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

'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.

John J. Tigue Jr. *Jeremy H. Temkin*

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, 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

John J. Tigue Jr. *is a principal in Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer and a fellow of the American College of Trial Lawyers.* **Jeremy H. Temkin** *is a principal in Morvillo, Abramowitz.* **Gretchan R. Ohlig,** *an attorney, assisted in the preparation of this article. Disclosure: Jeremy Temkin, represented the government in 'United States v. Bok,' 156 F.3d 157, 162 (2d Cir. 1998), both at trial and on appeal.*

of stock, ordinarily taxable to the shareholder as a capital gain.

The Court then distinguished between the "colorful behavior" alleged in the indictment (and apparently proved at trial) and the "objective economic realities" of the transactions. Thus, the Court found that the resolution of whether funds received from a corporation are a nontaxable return of capital or a taxable dividend may be determinative in a tax evasion case because without an actual tax deficiency, there can be no evasion.[12]

The Court rejected the Ninth Circuit's rule (set forth in *Miller*) that a criminal defendant can only treat a distribution as a return of capital if there is evidence of a corresponding contemporaneous intent by the corporation or shareholder to do so. The Court stressed that "the tax consequences of a 'distribution by a corporation with respect to its stock' depends, not on anyone's purpose to return capital or to get it back, but on facts wholly independent of intent: whether the corporation had earnings and profits, and the amount of the taxpayer's basis for his stock."[13]

The Court addressed the underlying rationale expressed by the Ninth Circuit in *Miller*. First, the *Miller* court believed that a focus on the statutory rules governing when a corporate distribution is a dividend, as opposed to a return of capital, "unnecessarily emphasize[d] the exact amount of deficiency while 'completely ignor[ing] one essential element of the crime charged: the willful intent to evade taxes.'"[14] Justice Souter rejected this rationale, which essentially conflates the deficiency and willfulness elements. Rather, he emphasized that the government must prove both of these elements and there is no predicate for tacking an intent requirement onto the statutory rules "distinguishing dividends from capital returns."[15]

The Ninth Circuit had also expressed concern that without requiring a showing of contemporaneous intent, a taxpayer who diverted and did not report funds from a close corporation having a bad year would be immune from punishment while a taxpayer who diverted and failed to report funds from a successful corporation would be subject to conviction.[16] The Supreme Court called this position "an extreme example of form over substance." Rather, relying on the Second Circuit's decision in *United States v. D'Agostino*, the Court noted that "[w]ithout the deficiency there is nothing but some act expressing the will to evade, and under §7201, acting on 'bad intentions alone [is] not punishable.'"[17] Thus, the Court rejected *Miller's* emphasis on the intent at the time of a transaction as a judicial expansion of "the reach of enacted crimes" and stated that "[i]f [the statutes] could stand amending, Congress will have to do the rewriting."[18]

Moreover, the Court was critical of any requirement that a taxpayer prove contemporaneous intent. First, the Court observed that the correct application of §§301 and 316 typically will only be known at the end of a corporation's tax year even though the distribution may have been made earlier. Accordingly, grafting a contemporaneous intent requirement onto the statute is inconsistent with the rule's application.[19] Second, the Court found that *Miller* would result in corporate distributions from entities without earnings and profits neither qualifying as a return of capital (for lack of contemporaneous intent to treat it that way) nor capital gains (because the distributions did not exceed the taxpayer's basis in the stock). Accordingly, the Court reasoned, the contemporaneous intent requirement "converts [§301] into one of merely partial coverage."[20]

Finally, the Court noted that, as acknowledged by the Ninth Circuit, the contemporaneous intent requirement creates liability in a criminal context where there is none in the civil context. According to Justice Souter, this disparity weighed heavily against adoption of the contemporaneous intent requirement.[21]

Saying that "tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than…the form the parties employed,'" the Court said a defendant could not be convicted of tax evasion absent evidence of an actual deficiency.

In its opinion, the Court noted that the government had claimed that, even without the contemporaneous intent requirement, Mr. Boulware's conviction should still be affirmed because his receipt of funds from HEI was unlawful and thus not subject to the return of capital rule. According to the government, the distributions made to Mr. Boulware were illegal because they were not made "with respect to [HEI's] stock." To support its position, the government argued that "[t]he Second Circuit has qualified its 'no earnings and profits, no income' rule by maintaining that the rule does not apply in cases 'of unlawful diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors.'"[22] Mr. Boulware, on the other hand, argued that it was sufficient that he demonstrate that he was a shareholder and that he did not receive the money in any nonstockholder capacity in order to satisfy the requirements under §301(a).[23] Observing that the Ninth Circuit had not considered these issues and that the jury had not been asked whether Mr. Boulware breached a fiduciary duty or otherwise unlawfully diverted the funds, the Court declined to address these arguments.

In addition to reversing Mr. Boulware's convictions for tax evasion under §7201, the Court also reversed the convictions under §7206(1) for making a false statement on a tax return. The Court acknowledged that §7206(1) does not require proof of a tax deficiency, but stated that "'the nature and character of the funds received can be critical in determining whether'" the statute has been violated. Indeed, in his brief, Mr. Boulware asserted that if the monies received were a return of capital, he could not be liable under §7206(1) for failure to report nonexistent income.[24] Noting that the government did not argue that the separate statutory convictions should be treated differently, the Court "accede[d] to the government's working assumption" that the convictions under §7206(1) stood or fell with those under §7201.[25]

Burden of Production

One issue that remains after *Boulware*, is whether the defendant bears any burden with respect to the application of the "no earnings and profits, no income" rule. The Supreme Court expressly declined to address "the more general question whether the Second Circuit's rule…, which places on the criminal defendant the burden to produce evidence in support of a return-of-capital theory, is authorized by…and consistent with [Supreme Court precedents]."[26] However, given its conclusions regarding the government's burden of establishing the existence of a deficiency, prosecutors should anticipate the possibility of a defense that corporate distributions constitute a return of capital and should include such proof in their case-in-chief.

1. __S.Ct.__, 2008 WL 552880 (March 3, 2008).
2. Id. at *6 (citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978)).
3. See 26 U.S.C. §§301(c)(1), 316(a).
4. Id. at §301(c)(2).
5. Id. at §301(c)(3).
6. See *United States v. Bok*, 156 F.3d 157, 162 (2d Cir. 1998); *United States v. D'Agostino*, 145 F.3d 69 (2d Cir. 1998). Disclosure: Jeremy Temkin, one of the authors represented the government in *Bok*, both at trial and on appeal.
7. *Bok*, 156 F.3d at 163-64.
8. 545 F.2d 1204 (9th Cir. 1976).
9. 470 F.3d 931, 934 (9th Cir. 2006).
10. Id. at 938.
11. 128 S.Ct. 32 (2007).
12. 2008 WL 552880 at *6).
13. Id.
14. 545 F.2d at 1214.
15. 2008 WL 552880 at *7.
16. 545 F.2d at 1214.
17. 2008 WL 552880 at *7.
18. Id. at *7 (citations omitted).
19. Id. at *8.
20. Id.
21. Id. at *9.
22. Brief for the United States, *Boulware v. United States*, No. 06-1509, 2007 WL 4254418, *34 (Dec. 3, 2007) (citing *D'Agostino*, 145 F.3d at 73; *Bok*, 156 F.3d at 162 n.1).
23. 2008 WL 552880 at *9 n. 14 (citations omitted).
24. Brief for Petitioner, *Boulware v. United States*, No. 06-1509, 2007 WL 3276503, *21 (Nov. 5, 2007).
25. Id. at *7 n. 9.
26. Id.