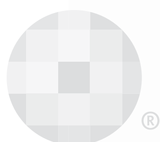
Practice

By Kathryn Keneally and Charles P. Rettig

Supreme Court Emphasizes Limits on Criminal Tax Enforcement: The *Boulware* Decision



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Criminal tax cases require the government to bring certain considerations to the prosecution that are different from most other federal criminal enforcement. The statutes setting out tax crimes were described by the Supreme Court in *M.R. Spies* as "a system of sanctions which singly or in combination were calculated to induce prompt and forthright fulfillment of every duty under the income tax law and to provide a penalty suitable to every degree of delinquency."[1] These statutes impose a heightened level of *mens rea*, requiring the government to prove that the defendant acted "willfully" by showing "that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty."[2]

Most recently, in *M.H. Boulware*,[3] the Supreme Court reiterated that, whether the crime of tax evasion can be proven will depend on whether, under the Internal Revenue Code, a tax deficiency exists. The government cannot, as it attempted in *Boulware*, merely point to alleged bad acts, even coupled with bad intent, by a taxpayer to support a charge of tax evasion. Rather, a criminal tax prosecution must remain grounded in the principles and requirements of the tax laws generally.

The Tax Evasion Charge and Defense in *Boulware*

The defendant in *Boulware* had been charged with a number of offenses, but only the elements of the crime of tax evasion under Code Sec. 7201[4] were before the Court. The defendant was the president and controlling shareholder of a closely held corporation. The evidence at trial established that he diverted millions of dollars from the corporation to his wife and his girlfriend that were not reported as income

on his personal income tax returns. The government offered evidence that the defendant wrote checks to employees and friends who in turn remitted cash to him, that he diverted payments from the company customers, that he submitted false invoices to the company and that he used offshore companies to conceal his activities.[5]

The defendant contended, in response, that the corporation had no retained earnings and profits in the tax years at issue, and that as a result any funds that he obtained from the corporation were nontaxable returns of capital, not taxable income. As the defense contended, the government could not prove a tax deficiency, and thus could not support a conviction under Code Sec. 7201.[6]

As has been noted often in this column and elsewhere, we are in an era of heightened tax enforcement.

The trial court refused to permit the defendant in *Boulware* to present evidence in support of this contention, and the Ninth Circuit affirmed. The lower courts appeared persuaded by the interaction of two points. First, as the Ninth Circuit summarized, the issue in a criminal tax case is whether the defendant acted willfully to attempt to evade the payment or assessment of tax, and second, the defendant offered no proof that the amounts at issue were considered to be or treated as the return of capital at the time that they were made.[7]

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The Supreme Court Reversed the Conviction in *Boulware*

The Supreme Court in *Boulware* unanimously held that "a defendant in a criminal tax case does not need to show a contemporaneous intent to treat diversions as returns of capital" before relying on Code Secs. 301 and 316(a) to establish that no taxes are owed.[8] In reaching this holding, the Court reiterated long-standing principles of law concerning criminal tax prosecutions.

Noting that Code Sec. 7201 has been described as the "capstone" of the "system of sanctions"[9] in the criminal tax statutes, the Supreme Court in *Boulware* reiterated that the existence of a tax deficiency is one element of the offense.[10] Unlike the lower courts in *Boulware*, the Supreme Court did not, therefore, limit its analysis to whether the defendant acted "willfully." Rather, the Court held that the determination of whether a tax deficiency exists requires an analysis of the transaction at issue under the applicable provisions of the Internal Revenue Code.

Quoting *Frank Lyon Co.*,[11] the Court in *Boulware* began its analysis by stating: "The colorful behavior described in the allegations requires a reminder that tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than … on the particular form the parties employed.'"[12] The Court turned to Code Secs. 301 and 316(a) to determine whether the defendant could claim that the funds at issue were the return of capital, even in the absence of any evidence that such treatment was intended when the distribution occurred.

Under Code Secs. 301 and 316(a), a distribution of property to a shareholder will be deemed a dividend includable in the shareholder's gross income to the extent that the distribution is made out of earnings and profits. The amount not treated as a dividend will be treated as a nontaxable return on capital, or as a taxable gain on the sale or exchange of stock, depending on the shareholder's basis in the stock.[13]

As the Supreme Court in *Boulware* concluded, the Code makes "the existence of 'earnings and profits' the decisive fact in determining the tax consequences of distributions from a corporation to a shareholder with respect to his stock."[14] The Court noted that, as written, the tax consequences of a distribution by a corporation with respect to stock under Code Secs. 301 and 316(a) do not depend on the intent of the corporation or the shareholder, but on the independent factors of whether the corporation had earnings and profits, and the shareholder's basis in the stock.[15] Indeed, as the Court noted, the correct treatment of distributions to a shareholder may often not be determined until the end of the corporation's tax year. Thus, even in the ordinary case, the parties may have clearly intended one form of treatment at the time of the distribution, but the proper tax treatment may differ as a result of subsequent events affecting the corporation's earnings and profits.[16]

Prior to the *Boulware* case, Ninth Circuit precedent had held that, in a criminal tax prosecution, the intent of the defendant needed to be considered in determining whether the corporate distributions should be

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treated as taxable income.[17] The Supreme Court found that this analysis erroneously conflated the government's burden of proving that the defendant acted with requisite intent willfully to violate the tax laws and its separate burden of proving a tax deficiency.[18]

Turning next to the argument that two taxpayers, engaging in identical wrongful acts concerning corporate funds, could face different consequences depending on whether the corporation had a profitable year, the Supreme Court in *Boulware* reasoned that to yield to this logic would erroneously relieve the government of the burden of proving the existence of a tax deficiency under Code Sec. 7201. Citing the Second Circuit's decision in *J. D'Agostino,* which had previously held that the government must establish a corporation's earnings and profits before a defendant accused of diverting corporate funds could be convicted under Code Sec. 7201, the Court summarized: "Without the deficiency there is nothing but some act expressing the will to evade, and, under § 7201, acting on 'bad intentions, alone, [is] not punishable.'"[19]

Open Issues in *Boulware*

The *Boulware* decision is notable for a number of issues that the Court identified but did not resolve. First, the government in *Boulware* argued that, for Code Secs. 301 and 316(a) to apply, the funds at issue must be a "distribution" made "with respect to … stock."[20] The Court found that the issue of whether the distributions were made "with respect to … stock" necessitated further review by the lower court based on the complete evidentiary record.[21] In a footnote, the Court noted strong language in various IRS pronouncements and decisions interpreting the statutes to the effect that a corporation and its shareholders share a common objective in profit-making, and that distributions need not be made proportionately among shareholders, for the provisions of Code Secs. 301 and 316(a) to apply.[22] On the issue of whether the diverted funds constituted a "distribution," the Court noted that the government was not disputing that the definition of distribution in Code Sec. 301(a) was "capacious enough" to cover the diversions at issue in the case.[23]

The government alternatively argued that unlawful diversions of corporate funds should not under any circumstances be treated as distributions under Code Secs. 301 and 316(a). The Court declined to address this issue, but rejected the contention that, in the absence of proper jury instructions, any inference could be made that the defendant had in fact engaged in an embezzlement or other act of wrongdoing against the corporation that he controlled.[24]

Next, the Court expressly did not reach the issue of whether the government or the defendant bears the burden of producing evidence in connection with the return-of-capital theory. The Court noted that the defendant did not dispute that he was required to produce some evidence, which the defendant contended required only that he show that he was a stockholder, that he did not receive payments in any nonstockholding capacity, that the corporation lacked sufficient earnings and profits, and that he had sufficient basis in his stock to cover the distribution. The government, in contrast, contended that the defendant must prove more. While not addressing the issue, the Supreme Court noted the general constitutional proscription against shifting the burden to the defendant in a criminal case.[25]

Finally, in a footnote, the Court in *Boulware* noted that the defendant was also convicted of violating Code Sec. 7206(1), which makes it a felony to willfully make or subscribe to a return or other statement under the penalties of perjury which the taxpayer "does not believe to be true and correct as to every material matter."[26] As the Court noted, all of the Circuit Courts of Appeals "are unanimous in holding that § 7206(1) does not require the prosecution to prove a deficiency."[27] Quoting the treatise Tax Fraud and Evasion by Comisky, Feld and Harris, the Court noted that "it is arguable that 'the nature and character of the funds received can be critical in determining whether … § 7206(1) has been violated, [even if] proof of a tax deficiency is unnecessary.'"[28] The Court did not, however, resolve the issue, noting that the government's arguments reflected a "working assumption … that the §§ 7201 and 7206(1) convictions stand and fall together."[29]

Lessons from *Boulware*

The Court in *Boulware* rejected an assertion that it was exalting form over substance. Foremost, the Court noted that, to hold that a defendant could be convicted of criminal tax evasion in the absence of a tax deficiency would more egregiously put form over substance by eliminating one element of the offense. Of equal significance, the Court properly required the government, in a criminal tax prosecution, to ground its case in the underlying tax laws. As the Court noted, "[i]t is neither here nor there whether … it would improve things to convict more of the evasively inclined by dropping

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the deficiency requirement and finding some other device to exempt returns of capital," because it is the obligations of the Court to enforce the statutes as written, not to recast them to fit a given prosecution's theory of wrongdoing.[30]

The Court in *Boulware* stated: "There is no reason to doubt that economic substance remains the right touchstone for characterizing funds received when a shareholder diverts them before they can be recorded on the corporation's books."[31] As has been noted often in this column and elsewhere, we are in an era of heightened tax enforcement. Too often, the government's efforts have been marked by aggressive and sometimes flatly erroneous attempts to expand the reach of the carefully wrought statutory tax scheme. In many of these cases, the government has sought to use economic substance as a shibboleth to challenge various tax transactions. In *Boulware*, the Supreme Court fittingly held that the standards can apply in both directions, holding the government to the language of the tax laws and the substance of the transaction.

Endnotes

1 *M.R. Spies*, SCt, 43-1 USTC ¶9243, 317 US 492, at 497.
2 *J.L. Cheek*, SCt, 91-1 USTC ¶50,012, 498 US 192, at 201.
3 *M.H. Boulware*, 128 SCt 1168, 2008 U.S. LEXIS 2356, 2008-1 USTC ¶50,206.
4 Code Sec. 7201.
5 *Boulware*, 2008 U.S. LEXIS 2356 at *10–11.
6 *Id.*, at *11.
7 *Id.*, at *12–13.
8 *Id.*, at *35.
9 *Id.*, at *7, quoting *Spies*, *supra* note 1, 317 US, at 497.
10 *Id.*, citing *M.C. Sansone*, SCt, 65-1 USTC ¶9307, 380 US 343, at 351.
11 *Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561, at 573.
12 *Boulware*, 2008 U.S. LEXIS 2356 at *16.
13 Code Secs. 301(a), 301(c) and 316(a).
14 *Boulware*, 2008 U.S. LEXIS 2356 at *9.
15 *Id.*, at *19.
16 *Id.*, at *25–26.
17 *M. Miller*, CA-9, 76-2 USTC ¶9809, 545 F2d 1204, at 1214.
18 *Boulware*, 2008 U.S. LEXIS 2356 at *20–29.
19 *Id.*, at *22-23, *quoting J. D'Agastino*, CA-2, 98-1 USTC ¶50,380, 145 F3d 69, at 73.
20 *Id.*, at *30–31.
21 *Id.*, at *31–32.
22 *Id.*, at *31, note 13.
23 *Id.*, at *30, note 12.
24 *Id.*, at *34–35.
25 *Id.*, at *32–33, note 14.
26 Code Sec. 7206(1).
27 *Id.*, at *23, note 9, *quoting L.T. Tarwater*, CA-6, 308 F3d 494, at 504.
28 *Id.*; *see* 1 I. Comisky, L. Feld & S. Harris, TAX FRAUD AND EVASION, ¶2.03[5], at 21 (2007).
29 *Boulware*, 2008 U.S. LEXIS 2356 at *23–24, note 9.
30 *Id.*, at *24.
31 *Id.*, at *18.

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