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Case at a Glance

The petitioner in this case is asking the Supreme Court to clarify whether the diversion of corporate funds to a corporate shareholder automatically qualifies as a nontaxable return of capital when the corporation has no earnings or profits and there is no evidence as to whether the diversion was intended as a return of capital.

Does a Taxpayer Have the Burden of Showing Intent to Divert Corporate Funds as Return of Capital?

by Michele LaForest Halloran

PREVIEW of *United States Supreme Court Cases*, pages 156-159. © 2008 American Bar Association.

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Major corporate shareholders frequently invest capital in their corporate enterprises, and their returns of this invested capital may not constitute income under I.R.C. § 301(c)(2). Some of these taxpayers have been known to divert corporate funds into their personal pockets. While this may not necessarily constitute a violation of corporate law precepts, it has harsh, potentially criminal, income tax implications. When defending criminal tax evasion charges for diversion of corporate funds for which individual income taxes have not been paid, a taxpayer may attempt to prove that he had no tax deficiency by asserting that the monies the government alleges constitute unreported income in fact simply were nontaxable returns of capital, whether or not they originally were intended to be such. In alignment with the governing statute, a taxpayer who claims the nontaxability of such sums will attempt to demonstrate that the corporate enterprise lacked earnings and profits, and that the amount of money diverted was not greater than

the taxpayer's basis in his stock. This evidence, if presented and accepted, negates elements of certain tax-related crimes, thereby undermining the prosecution.

However, there is a conflict between the Ninth and Second Circuits (as well as other Circuits) concerning the ease with which a taxpayer may introduce return of capital evidence. The Ninth Circuit, in *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), restrictively ruled that, in the criminal context, a taxpayer must first show, contemporaneous with the distribution, an intent that the payment is a return of capital before he will be permitted to introduce return of capital evidence and speak to the principles set forth in I.R.C. §§ 301 and 316. On the other hand, the Second Circuit, in *United States v. Bok*, 156 F.3d 157 (2nd Cir. 1998), and *United States v. D'Agostino*, 145 F.3d 69 (2nd Cir. 1998), determined that there is no contemporaneous intent requirement, and that a taxpayer defending criminal charges has the same ability as a taxpayer contesting a civil tax matter to present return of capital evidence.

BOULWARE v. UNITED STATES
DOCKET NO. 06-1509

ARGUMENT DATE:
JANUARY 8, 2008
FROM: THE NINTH CIRCUIT



ISSUE

The issue identified by the U.S. Supreme Court in granting the writ of certiorari in this case, see, 128 S. Ct. 32, is: “Whether 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, see 26 U.S.C. § 301(c)(2) even if the diversion was not intended as a return of capital.”

FACTS

Petitioner Michael Boulware owned at least half the stock, and was founder, chairman, and president, of Hawaiian Isles Enterprises (HIE), a company that sells coffee, water, and other items. The government charged him with multiple counts of willfully filing false tax returns and willfully attempting to evade tax, and one count of conspiring to make a false statement to a federally insured financial institution, claiming that he failed to report approximately \$10 million in income that he allegedly diverted from HIE in a variety of ways. Boulware was convicted on all counts after a trial in district court, but the Ninth Circuit, while affirming the conspiracy conviction, reversed the tax-related convictions on grounds that certain evidence relating to a state court judgment in an action brought by his girlfriend to determine the ownership of funds had been improperly excluded. The Ninth Circuit then remanded the case for a new trial. *United States v. Boulware*, 384 F.3d 794 (9th Cir. 2003).

At his new district court trial, Boulware adopted the following strategy: he attempted to present evidence, and requested that the jury be instructed, that the money he received from HIE represented nontaxable returns of capital he had invested in the company. The gov-

ernment sought to limit Boulware’s proposed evidentiary presentation on grounds that *Miller* requires that a taxpayer first show that the disputed distributions were contemporaneously intended to be a return of capital before the rules pertaining to these distributions will apply in a criminal tax proceeding. The district court agreed, stating that when offering “return of capital” evidence, Boulware cannot merely contend that the monies *could have* constituted a return of capital—instead, he must show that the funds in fact were a return of capital. Because Boulware was unable to meet this foundational standard—he could not demonstrate that the funds *in fact* were a return of capital—the district court refused to admit this evidence and declined to instruct the jury as requested.

Boulware again was convicted on the tax counts and sentenced to imprisonment, and his conviction and sentence were affirmed on appeal. *Boulware v. United States*, 470 F.3d 931 (9th Cir. 2006). On appeal, the Ninth Circuit rejected Boulware’s claim that the district court misread the holding in *Miller*, stating that it “disagree[d] that any part of *Miller’s* reasoning can be disregarded.” Accordingly, the appeals court confirmed that the manner in which diverted funds may be characterized for civil tax purposes is not controlling in the context of criminal proceedings, and that “the appropriate characterization for criminal purposes is whether the defendant has willfully attempted to evade the payment or assessment of a tax,” a question that is not resolved by simply showing that the event would be nontaxable had the taxpayer followed a different path. And, in response to Boulware’s contention that imposition of a requirement that the taxpayer show that he intended a return of capital unconstitutionally shifted the burden of

proof to the taxpayer, the court stated that once the government has shown that the taxpayer diverted funds from the corporation and failed to pay taxes on the diverted funds, the burden of proof lawfully shifts to the taxpayer to show that the funds reflected a return of capital. Because Boulware did not show that the diverted funds were intended to be a return of capital at the time they were taken, he failed to lay an adequate foundation for his defense, and the district court properly rejected it.

The United States Supreme Court granted a writ of certiorari to review the decision of the Ninth Circuit Court of Appeals. *Boulware v. United States*, 128 S. Ct. 32 (2007). As previously noted, the Court’s order granting the writ specified the question to be addressed by the parties as: “Whether 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, see 26 U.S.C. § 301(c)(2) even if the diversion was not intended as a return of capital.”

CASE ANALYSIS

In considering the *Boulware* case, a review of the contrary decisions of the Second Circuit is helpful. The first Second Circuit case, *D’Agostino*, involved a couple who owned a business and were convicted of multiple counts of tax evasion and attempted tax evasion. Testimony at their district court trial revealed that, over time, they had diverted corporate funds for personal use, and that the couple had not reported this income on their individual income tax returns. Their accountants testified that the corporation had made significant loans to them, and that the couple had invested substantial capital in the

(Continued on Page 158)

entity. That the corporation had no earnings and profits during the tax years in issue was undisputed. The district court instructed the jury that if it found beyond a reasonable doubt that the taxpayers did not intend the funds to be a return of capital at the time of the distribution, then the monies would constitute taxable income. The couple was convicted on all accounts, and appealed to the Second Circuit Court of Appeals.

In considering whether the government had met its burden of proving that the D'Agostinos were personally liable for unpaid income taxes vis-à-vis the corporate distribution, the Second Circuit, citing three previous cases and an IRS Action on Decision involving both civil and criminal matters, noted that "[i]n this Circuit, corporate funds lawfully diverted by a shareholder constitute taxable income only to the extent that the corporation had earnings and profits during the tax year in which the diversion occurred." 145 F.3d at 72. The court noted the existence of an Eleventh Circuit case to the contrary, *United States v. Williams*, 875 F.2d 846 (11th Cir. 1989), which the government urged it to adopt, but declined to circumvent binding precedent within the circuit. Further, the court found the rule of its own Circuit to be "better reasoned." According to the court, "[t]he *Williams* rule purports to minimize the government's burden of proving a tax deficit and places greater emphasis on the intent element in criminal tax evasion cases. The apparent result, however, is that the government bears a higher burden of proof in a civil tax collection matter than in a criminal tax evasion prosecution. In addition, the approach taken in *Williams* and *Davis* [*Davis v. United States*, 226 F.2d 331 (6th Cir. 1955)] effectively eliminates proof of a tax deficiency

as an element of a 26 U.S.C. § 7201 violation. Under the *Williams* rule, the government would only need to prove that the taxpayer willfully intended to exercise domain and control over the diverted funds and took affirmative acts to evade paying taxes. If Congress intended this showing to suffice to establish a violation of § 7201, it would not have included a tax deficit as a requisite element." On this basis, the court reversed the D'Agostinos' convictions and remanded the case to the district court with a direction that the judgments be vacated and the indictments dismissed.

The other pertinent Second Circuit case, *United States v. Bok*, 156 F.3d 157 (2nd Cir. 1998), involved the president and sole shareholder of a construction company who was indicted, tried, and convicted for tax evasion and making false statements on an income tax return on account of his appropriation of corporate funds for personal use. At Bok's district court trial, the judge refused to instruct the jury that the money he diverted from the corporation may have been a nontaxable return of capital. The Second Circuit affirmed Bok's convictions, but not on grounds that it is never appropriate to so instruct the jury in criminal cases. To the contrary, the court provided a thorough exposition of a taxpayer's ability to maintain a return of capital defense, and confirmed that the defense has equal application in civil and criminal cases. The court further instructed that "a taxpayer's intent is not determinative in defining the taxpayer's conduct. That is, the taxpayer or the corporation need not have described the distribution at issue as a dividend or a return of capital at the time it was made; rather, the realities of the transaction—including the amount of the shareholder's basis and the corporation's earnings or profits, as well as the amount of

the distribution—govern its characterization for tax purposes."

In his Supreme Court brief, Boulware asserts that the *Miller* contemporaneous intent requirement has no basis in the governing statute, and that all a criminal defendant need show to put on his return of capital defense is that the corporation was without earnings and profits and that the distribution did not exceed his stock basis for the year in issue. He also maintains that I.R.C. § 301 applies to both civil and criminal tax cases, and that *Miller's* analysis of the return of capital doctrine is wrong for three reasons: (1) citing *D'Agostino*, Boulware contends that it eliminates proof of a tax deficiency as an element of criminal tax evasion; (2) it creates an anomalous situation, in that a taxpayer may incur no civil liability under a return of capital analysis, but yet, based upon the same distribution, may be subjected to criminal liability; and (3) as previously stated, there is no statutory foundation for imposition of a contemporaneous intent requirement.

Boulware takes issue with the government's assertion in opposing his application for a writ of certiorari that the phrase "with respect to its stock" set forth in I.R.C. § 301(a) supports *Miller's* imposition of a contemporaneous intent requirement. According to Boulware, this phrase simply distinguishes money the taxpayer receives in his capacity as a corporate shareholder from money he receives in other capacities, and does not give rise to an intent requirement. Finally, Boulware submits that even if the Supreme Court determines that some forms of unlawful diversion are not within I.R.C. §§ 301 and 316, he is still entitled to reversal and remand for a new trial, for the reason that the government must still prove the unlawfulness of the diversion to a jury.

To the contrary, the United States in its brief asks the Supreme Court to hold that a taxpayer who has diverted funds from a corporation without earnings and profits is not automatically entitled to assert a return of capital defense because such a holding is not in line with the language of I.R.C. § 301, and opens the door to tax fraud. Under the precise language of § 301, the distribution to the taxpayer must have been a payment to the shareholder in his shareholder capacity, and there is no default rule that any distribution made to the shareholder automatically qualifies as such. Accordingly, before a taxpayer can avail himself of a nontaxable return of capital defense, he must show that the diverted funds were intended to be a distribution to him in his shareholder capacity.

The government also asserts that acceptance of Boulware's argument concerning automatic treatment of diverted funds as a return of capital would subvert the congressional purpose to impose income tax on lawful, as well as unlawful, gains and would have the effect of endorsing the diversion of corporate funds to personal use without income tax consequences. Further, the government does not see that an inconsistency exists between civil and criminal tax cases as concerns the return of capital defense—according to the government, there is no automatic rule in either context, and it is critical in both instances that the property distribution must have been made by a corporation to a shareholder with respect to the shareholder's stock. The government also disputes Boulware's claim that the Ninth Circuit's decision reduces the prosecution's burden of proof, stating that the real issue lies with the legitimacy of the return of capital defense, not with which party has the burdens of proof and production. Finally, the government

advised the Court that Boulware's convictions should be affirmed—even if the only elements of a return of capital defense are that the corporation had no earnings and profits and that the diverted funds did not exceed the shareholder's basis—because his diversion was an unlawful one, and therefore, the return of capital defense is inapplicable, as even *D'Agostino* and *Bok* acknowledge.

SIGNIFICANCE

While the core issue to be addressed case does not have widespread significance to the general taxpaying public, it does have direct pertinence to criminal tax evasion cases involving significant corporate shareholders prosecuted for diversion of corporate funds for personal use and nonpayment of income taxes on those sums. A decision in favor of the taxpayer will seriously impair the ability of the prosecution in these types of cases to show that the diverted sums create a tax deficiency. On the other hand, a decision in favor of the government will greatly advance its ability to convict persons whose actions in diverting funds and failing to pay income taxes on those sums have been substantially less than forthright.

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