A Smidgen of Willfulness

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These days there is considerable talk about the meaning of willfulness. What is willful behavior on the one hand, and what constitutes more forgivable mistakes on the other? The concept of *mens rea*, or guilty mind, may sound like the pure province of criminal law, far removed from the boardroom or the plush carpet of the C suite. Yet the concept can come up in surprisingly varied contexts.

For example, corporate and securities filings can raise this issue, as can tax filings. Indeed, even without mentioning putatively criminal behavior, a whole raft of civil penalties can apply if the IRS or a court decides that the taxpayer's behavior was not reasonable. Sometimes one can defend based on the taxpayer's own conduct and diligence.

Sometimes a tax opinion or tax professional's advice will do the trick. Sometimes the IRS could assert big penalties but is happy enough to collect the taxes and interest. Sometimes the penalties take over as the biggest or even the only issue in the case.

Are we talking purely about tax-motivated transactions you might fairly label as tax shelters? Not necessarily. Indeed, in a host of well-publicized transactions that were essentially business sales, high-profile people have been roped into putatively criminal behavior. Dolce & Gabbana and Lionel Messi come to mind.

Domestically, even without cataloging the panoply of types of cases that can raise willfulness issues, it is worth noting the recent uptick in authorities addressing the point. A case that is entertaining to read, but that may send a chill down the spine of many a tax adviser, involved Electronic Arts founder Trip Hawkins. The case is *Hawkins v. Franchise Tax Board, et al.* [CA-9, 2014-2 USTC ¶50,439].

Gaming the System

On the surface, Hawkins' case is about whether lavish spending is itself tax evasion, but its conclusions on willfulness may have a broader impact on other areas of the tax law. Trip Hawkins had flush years and then fell on hard times. He once had an estimated net worth of $100 million, a private jet, million-dollar homes and even a private staff.

He participated in the infamous FLIP and OPIS KPMG tax shelters and, as a result, claimed substantial losses on his tax returns. He would end up in big tax trouble and big marital trouble, too. In 2003, Hawkins filed a motion in family court to reduce his large child-support payments. The family court filing admitted that he owed more than $20 million to the IRS, had limited income and was insolvent.

In 2005, the IRS assessed Hawkins with $21 million in tax for the years 1997 through 2000. In July 2006, Hawkins sold his primary residence and paid the entire $6.5 million net proceeds to the IRS. A month later, California's notorious Franchise Tax Board (FTB) seized $6 million from various financial accounts.

In September, Hawkins filed a Chapter 11 petition, primarily for the purpose of addressing the tax liabilities. Yet despite all these setbacks, Hawkins' foot remained on the gas. In fact, the Bankruptcy Court found that Hawkins did little to alter his lavish lifestyle even after he knew he was insolvent and had outstanding tax debts.

On this basis, the court agreed with the IRS and FTB that his tax debts were excepted from discharge pursuant to 11 U.S.C. Section 523(a)(1)(C). That provision excepts from discharge any debt "with respect to which the

debtor … willfully attempted in any manner to evade or defeat such tax."

Specific Intent

The Ninth Circuit found that Section 523(a)(1)(C) imposes a "specific intent" requirement on the taxpayer's conduct. The court noted that the language in Section 523(a)(1)(C) was almost identical to the language used in 26 U.S.C. Section 7201, which makes it a felony offense to "willfully attempt[] in any manner to evade or defeat any tax." Moreover, the court observed that the Bankruptcy Code was designed to give debtors a fresh start and that the word "willfully" should be interpreted in this context.

The Ninth Circuit cited Supreme Court authority that, "almost invariably," such an attempt to evade or defeat taxes will "involve deceit or fraud upon the Government, achieved by concealing a tax liability or misleading the Government as to the extent of the liability." Simply spending beyond one's means, in the circuit court's view, does not qualify as a willful attempt to "evade or defeat" such tax.

The Ninth Circuit even acknowledged that other courts have mentioned lavish lifestyles in this context, but found that no circuit has held that this alone constitutes willful evasion. The court remanded the case for willfulness to be reconsidered in light of the specific-intent requirement it articulated.

The dissent reasoned that the majority's "fresh start" analysis could easily "eclipse all discharge exceptions." The dissent also cited to *Vaughn v. IRS (In re Vaughn)* [2014 U.S. App. LEXIS 16417 (10th Cir. Aug. 26, 2014)], involving a taxpayer who failed to preserve assets despite knowledge of substantial tax liability. Mr. Vaughn had "numerous large expenditures" and was found to be willful.

The dissent argued that Hawkins willfully attempted to avoid payment of taxes and that he did this "through profligate spending." There is an understandable appeal to this view, a kind of "walks-like-a-duck" logic. Even so, it is hard to ignore the specific-intent language in the statute, which the dissent arguably did.

The Bankruptcy Court and District Court sided with the government, finding that willfulness merely requires knowledge of a duty to pay taxes and voluntary and intentional violation of the duty. But the Ninth Circuit said lavish spending, without more, cannot prevent a tax debt from being discharged. According to the Ninth Circuit, intentional violations of one's duty to pay taxes must be done for the "purpose of evading taxation." Simply continuing to spend money lavishly is not an *act of evasion*, the court said.

Like a Duck?

The court gave examples of acts that *might* qualify as evasive. These include concealing assets through nominee accounts, concealing ownership in assets, failing to file tax returns and pay taxes. Also of interest to deal mavens, the court mentioned structuring financial transactions.

But the government had failed to show that Hawkins did *any* of these earmarks of evasion. The Ninth Circuit remanded for further proceedings. In that sense, the jury is still out on Hawkins.

It is also too early to tell if other circuits will follow the Ninth Circuit's lead. If they do, *Hawkins* could have broad implications for tax controversies. For instance, *Hawkins* could call into question the IRS's jeopardy collection procedures.

It is not a crime to spend lavishly when faced with a tax debt, although it is a crime to "conceal" assets. [26 U.S.C. § 7206(4).] Nevertheless, the Tax Code provides that if a taxpayer is dissipating assets, the IRS can accelerate collection action. [26 U.S.C. § 6851.] The IRS currently interprets this to include any spending beyond one's means.

Hawkins calls this interpretation into question. In order to issue a "jeopardy" levy, perhaps the IRS will have to document an act of evasion rather than mere excessive spending. The IRS could claim that dissipation is plainly a bad act under the tax code since it triggers jeopardy collection procedures.

Jeopardy Levies

What if the IRS had tried to use jeopardy collection procedures in order to halt Hawkins' lavish spending? The Tax Code allows the IRS to accelerate collection action if a taxpayer is, or appears to be, placing assets beyond the reach of tax collection. Code Sec. 6851(a)(1) provides for jeopardy assessments in the following cases:

> If the Secretary finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal

himself or his property therein, *or to do any other act* (including in the case of a corporation distributing all or a part of its assets in liquidation or otherwise) tending to prejudice or to render wholly or partially ineffectual proceedings to collect the income tax for the current or the immediately preceding taxable year unless such proceeding be brought without delay.

Does "do any other act" include mere lavish spending? The statute could be read this way, although there are not many cases on point. The Internal Revenue Manual currently defines a dissipated asset as one that has been "sold, transferred, encumbered, or otherwise disposed of . . . in an attempt to avoid payment of the tax liability or *use the assets or proceeds ... for other than the payment of items necessary for the production of income or the health and welfare of the family*, after the tax has been assessed or within six months prior to the tax assessment" (emphasis added). [IRM § 5.8.5.18.7.]

One danger for the IRS is that this formulation sounds quite similar to the government's rejected position in *Hawkins*. Although the contexts are different, the government argued that either specific deceptive acts *or* lavish spending could trigger nondischargeability of taxes. *Hawkins* concludes that only the former can qualify.

Even if wasteful spending can trigger jeopardy procedures, how does one know when a taxpayer has gone over the line? The IRS has recognized that withdrawing assets, and even liquidating them, can be necessary to pay reasonable living expenses. [*L. Layton*, 102 TCM 160, Dec. 58,728(M), TC Memo. 2011-194.] Articulating what is a reasonable living expense may be difficult, especially in a tense jeopardy collection situation.

The IRS has some answers as to what counts as a reasonable living expense. In fact, the IRS prescribes detailed cost-of-living calculations and formulas to determine acceptable levels of spending. It can make sense to use national standards to calculate payments under an installment agreement.

Still, a one-size-fits-all approach can yield ill-fitting results. Even the Bankruptcy Court in *Hawkins* suggested that a taxpayer's particular facts matter. The Bankruptcy Court sensibly noted that it "may not be appropriate to require a CEO earning hundreds of thousands of dollars per year to live in an apartment suitable for a clerical employee, even if that CEO is insolvent." [430 B.R. at 237.]

The IRS can expect some taxpayers faced with jeopardy levies to cite *Hawkins* and claim that the government is being unreasonable, if not unlawful. With willfulness, context is crucial. In employment tax collection cases, dissipating corporate funds after knowing that the taxes are due is *per se* evidence of willfulness regarding trust fund recovery penalties. [26 U.S.C. § 6672.] This is true even if the corporate officer is simply following directions from a superior. *Hawkins* may be of little help to such a taxpayer, even if they are merely following directions from someone higher up the corporate chain.

Conclusion

However much the IRS may be flummoxed by the Ninth Circuit's vote for Hawkins, the court's conclusion is surely correct. After all, the statute in question, Section 523(a)(1)(C) of the Bankruptcy Code, requires a willful attempt to "evade or defeat" taxes. Hawkins may have behaved in an unseemly and irresponsible manner, but was he willful?

It is hard to see how excessive spending alone manifests a willful attempt to evade or defeat taxes. At the same time, the decision is hardly a missive for tax evaders, big spenders, offshore account deniers and others to do their worst. It is not yet clear whether the decision will impact willfulness analysis in other contexts.

Notably, there is no express requirement that the rules for bankruptcy dischargeability parallel jeopardy collection procedures. Taxpayers are likely to argue that excessive spending, without more, *cannot* trigger jeopardy collection post-*Hawkins*. Conversely, the government is likely to argue that *Hawkins* was incorrectly decided, citing these very same jeopardy collection rules.

Context is crucial, and the government must prove its case for whatever standard of penalties or behavior is being examined. But any way you slice it, *Hawkins* seems likely to mean that there will be more arguments from the government and more from taxpayers. When one starts thinking of all the things that can go wrong in the corporate context, the list can be dizzying.

It may seem that lavish spending in a corporate context is the least likely thing

one is to see today. We are, presumably, no longer living in the $6,000-shower-curtain era of former Tyco chief Dennis Koslowski. Maybe, but we could easily have more contemporaneous badges of something the government doesn't like.

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