Lavish Spending and Other 'Non-Willful' Acts With Taxes and FBARs

By Robert W. Wood and Dashiell C. Shapiro

Robert W. Wood

Dashiell C. Shapiro

Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009, with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com. Dashiell C. Shapiro practices law with Wood LLP and was previously a trial attorney with the Justice Department Tax Division. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

In this article, Wood and Shapiro discuss the Ninth Circuit's decision in *Hawkins* and the degree to which taxpayer actions could be considered willful attempts to evade or defeat taxes.

Canadian rapper Drake has popularized lyrics extolling the feeling one can get from skirting taxes while living large. Yes, "there's some bills and taxes I'm still evading," he boasts, "but I blew 6 million on myself and I feel amazing."[1]

Surely Drake is not the only one to feel amazing after blowing money on luxuries instead of paying taxes. Electronic Arts Inc. founder Trip Hawkins may be feeling pretty good as well, following his recent victory in the Ninth Circuit.[2] And much to the distress of the IRS,[3] others may follow his example.

On the surface, *Hawkins* is about whether lavish spending is itself tax evasion, but its conclusions on willfulness may have a broader effect on other areas of tax law. Willfulness is much in the news, from Lionel Messi to Dolce & Gabbana to Beanie Babies.[4] It is also a key point of concern in offshore bank account cases, in which taxpayers often seek reassurance that their missteps, even if ill-advised, surely weren't willful.

Video Gamer's Surprising Trip

Hawkins had big 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.[5] He participated in the infamous FLIP and OPIS KPMG tax shelters, and as a result claimed substantial losses on his tax returns.[6] He would end up in big tax trouble, and big marital trouble, too.

In 2003 Hawkins filed a motion in family court to reduce the large child support payments he was required to make to his first wife. The family court filing disclosed that he owed $25 million to the IRS, had limited income, and was insolvent.[7] In 2005 the IRS assessed Hawkins with $21 million in tax for the years 1997 through 2000.[8] In July 2006 Hawkins sold his primary residence and paid the entire $6.5 million net proceeds to the IRS.[9]

A month later, the Franchise Tax Board seized $6 million from various financial accounts.[10] In September, Hawkins filed a chapter 11 petition, primarily for the purpose of addressing the tax liabilities.[11]

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[1] Drake, "The Ride," on *Take Care* (Cash Money Records, 2011).

[2] *Hawkins v. Franchise Tax Board of California et al.*, No. 11-16276 (9th Cir. 2014).

[3] The Justice Department has requested *en banc* review of the decision, Case No. 11-16276, Dkt. No. 69 (Oct. 29, 2014).

[4] Robert W. Wood, "Dolce & Gabbana Cleared of Tax Evasion, Could Help Lionel Messi Trial," *Forbes*, Oct. 25, 2014; Wood, "Beanie Babies Founder Ty Warner to Pay $53M for Offshore Tax Evasion," *Forbes*, Sept. 18, 2013.

[5] *Hawkins* (9th Cir. 2014), at 4.

[6] *Id.* at 5.

[7] *Id.* at 6.

[8] *Id.* at 7.

[9] *Id.*

[10] *Id.* at 7.

And here the plot thickens. Despite all these setbacks, Hawkins's foot remained firmly on the gas.

In fact, the Bankruptcy Court specifically found that Hawkins did little to alter his lavish lifestyle even after he knew he was insolvent and had outstanding tax debts.[12] On this basis, the court agreed with the IRS and FTB that his tax debts were excepted from discharge under 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."[13]

Specific Intent and the Bankruptcy Code

The Ninth Circuit found that 11 U.S.C. section 523(a)(1)(C) imposes a "specific intent" requirement on the taxpayer's conduct.[14] The court noted that the language in 11 U.S.C. section 523(a)(1)(C) was almost identical to the language used in section 7201, which makes it a felony offense to "willfully attempt in any manner to evade or defeat any tax."[15] 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.[16]

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."[17] Simply spending beyond one's means, in the circuit court's view, does not qualify as a willful attempt to "evade or defeat" that tax.[18]

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.[19] The court remanded the case so that willfulness could be reconsidered in light of the specific intent standard it articulated.[20]

The dissent reasoned that the majority's "fresh start" analysis could easily "eclipse all discharge exceptions."[21] The dissent also cited *Vaughn*,[22] which involved a taxpayer who failed to preserve assets despite knowledge of substantial tax liability. Vaughn had "numerous large expenditures," and was found to be willful.[23]

The dissent argued that Hawkins willfully attempted to avoid payment of taxes and that he did this "through profligate spending."[24] 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."[25] Simply continuing to spend money lavishly is not an act of evasion, the court said.

What's Evasive, What's Willful?

The court gave examples of acts that might qualify as evasive. Those included concealing assets through nominee accounts, concealing ownership in assets, failing to file tax returns and pay taxes, or structuring financial transactions. But the government failed to show that Hawkins did any of these, so the Ninth Circuit remanded for further proceedings.

It is too early to tell if other circuits will follow the Ninth Circuit's lead. But 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] Nevertheless, the tax code provides that if a taxpayer is dissipating assets, the IRS can accelerate collection action.[27] The IRS currently interprets

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[11] *Id.*

[12] *Hawkins v. Franchise Tax Board (In re Hawkins)*, 430 B.R. 225, 236-237 (Bankr. N.D. Cal. 2010); *see also Hawkins v. Franchise Tax Board*, 447 B.R. 291, 295-296 (N.D. Cal. 2011) (affirming Bankruptcy Court's decision).

[13] *Id.*

[14] *Hawkins* (9th Cir. 2014), at 2.

[15] *Id.* at 3.

[16] *Id.* at 9.

[17] *Id.* at 13 (citing to *Kawashima v. Holder*, 132 S. Ct. 1166, 1175, 1177 (2012)).

[18] *Hawkins* (9th Cir. 2014), at 13-14.

[19] *Id.* at 15.

[20] *Id.*

[21] *Id.* at 16-19 (J. Rawlinson, dissenting).

[22] *Vaughn v. IRS (In re Vaughn)*, No. 13-1189 (10th Cir. 2014).

[23] *Id.* at 16, n.5.

[24] *Hawkins* (9th Cir. 2014), at 19 (J. Rawlinson, dissenting).

[25] *Id.* at 15.

[26] Section 7206(4) provides that any person who "removes, deposits, or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for or in respect whereof any tax is or shall be imposed or any property upon which levy is authorized by section 6331, with intent to evade or defeat the assessment or collection of any tax imposed by this title . . . shall be guilty of a felony."

[27] Section 6851 (termination assessment, allowing the IRS to close the current tax year to immediately assess tax owned);

(Footnote continued on next page.)

this to include any spending beyond one's means. *Hawkins* calls this interpretation into question. To issue a ''jeopardy'' levy, perhaps the IRS will have to document an act of evasion rather than mere excessive spending.

The IRS is likely to take the contrary position. It might argue that *Hawkins* was wrongly decided, and cite the dissipation rules for support. The IRS could claim that dissipation is plainly a bad act under the tax code, because it triggers jeopardy collection procedures.

Of course, the positions are not mutually exclusive. Even if Hawkins's lavish spending is not per se evidence of willfulness, perhaps the government still possessed jeopardy collection powers to prevent it before he declared bankruptcy. In any case, the dissipation rules may become a focus of subsequent tests of the Ninth Circuit's analysis.

Hawaii Trip Could Trigger a Jeopardy Levy

What if the IRS had tried to use jeopardy collection procedures to halt Hawkins's 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.[28]

Section 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. [Emphasis added.]

Does the phrase ''do any other act'' include mere lavish spending without any evasive purpose? The statute could be read this way, although there are not many cases on point.[29]

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.''[30]

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 crossed the line? The IRS has recognized that withdrawing assets, and even liquidating them, can be necessary to pay reasonable living expenses.[31] Articulating what is a reasonable living expense may be difficult indeed, especially in a tense jeopardy collection situation.

The IRS has some answers for 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.[32] It can make sense to use national standards to calculate payments under an installment agreement. Of course, it is much more problematic to base a jeopardy lien or levy on the grounds that someone is spending more than the allotted amount on clothing, entertainment, or plastic surgery. Indeed, a one-size-fits-all approach may not work for many taxpayers. 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.''[33] The IRS can expect some taxpayers faced with jeopardy levies to cite *Hawkins* and claim that the government is being unreasonable, if not unlawful. Imprisoned former Tyco International Ltd. CEO Dennis Kozlowski may never get

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section 6861 (jeopardy assessment, allowing the IRS to immediately assess taxes owed without 90-day notice of deficiency); Internal Revenue Manual section 5.8.5.18.

[28]Section 6851 (termination assessment, allowing the IRS to close the current tax year to immediately assess tax owned); section 6861 (jeopardy assessment, allowing the IRS to immediately assess taxes owed without 90-day notice of deficiency).

[29]*See Tucker v. Commissioner*, T.C. Memo. 2011-67, at 10-11 (in collection due process case, dissipation of assets included day-trading losses when the trades were made in an attempt to satisfy the tax liability).

[30]IRM section 5.8.5.18 (Sept. 30, 2013) (emphasis added).

[31]*See Layton v. Commissioner*, T.C. Memo. 2011-194, at 5 (''When the taxpayer can show that assets have been dissipated to provide for necessary living expenses, these amounts should not be included in the RCP [reasonable collection potential] calculation, including for example, 'dissolving an IRS account to pay for necessary living expenses during unemployment' '').

[32]IRS Collection Financial Standards (effective Mar. 31, 2014).

[33]*Hawkins*, 430 B.R. at 237 (''The effort and skill required to earn such sums require a nuanced approach in determining what living expenses are necessary. Even the most nuanced approach, however, does not excuse living expenses greatly in excess of earned income over an extended period of time.'').

to expense a $6,000 shower curtain again, but his allies are likely to be reading *Hawkins* closely.

Willfulness and Offshore Accounts

Hawkins could also affect foreign account cases. There is a fight brewing between taxpayers and the IRS regarding what constitutes ''willful'' failure to file a foreign bank account report.[34] Many taxpayers have applied for the IRS's new streamlined and transitional relief programs, which require taxpayers to certify that they were non-willful in their failure to report offshore accounts and pay related taxes.[35]

Many of these cases are just beginning to make their way through the audit pipeline and then to court. If *Hawkins* is read broadly, it could suggest that simply having an unreported foreign account should not trigger willfulness penalties.

In other willfulness cases, *Hawkins* may be of little help to taxpayers. With willfulness, context is crucial.[36] Notably, in employment tax collection cases, dissipating corporate funds after knowledge of employment taxes is per se evidence of willfulness regarding trust fund recovery penalties.[37] This is true even if the corporate officer is simply following directions from a superior.[38]

But in offshore cases, the definition of willfulness is still very much open to dispute. The IRS can often point to a taxpayer's Form 1040, which asks, ''At any time [during the tax year], did you have an interest in a foreign country, such as a bank account, securities account, or other financial account?'' If the taxpayer has said no, the IRS may claim that the failure to report any foreign accounts was willful.

On the other hand, even in those cases taxpayers may have strong arguments that they were not willful. If the foreign account earned little income, consisted of assets that were already reported and taxed, or was established for purposes other than tax evasion, arguably willfulness is not present.

If taxpayers and the IRS do not agree on willfulness in a request for ''transitional relief,'' taxpayers can opt out of the program and take their case to IRS Exam and Appeals.[39] Taxpayers that opt out can ultimately take their cases to court, and these cases will likely turn on whether the taxpayers ''willfully'' failed to report their offshore accounts.[40]

However, there is little case law in this area, and it is not clear how the term ''willfulness'' should be applied. The relevant statute provides penalties for both willful and non-willful failure to file FBARs.[41] The willfulness penalties can be quite significant, and can constitute 50 percent of the account balance for each year.[42]

The statute itself provides little insight into the proper definition of willfulness.[43] Tax professionals are getting more questions about this than ever before. To add to the nuances, there is a reasonable cause exception under section 6662, yet there is little case law on how these separate provisions interact.[44]

In other words, the definition of willfulness as it concerns failure to file FBARs might be up for grabs. If *Hawkins* is read broadly, it could suggest that individuals who use foreign accounts for reasons other than tax evasion may have stronger arguments on willfulness. Indeed, it is arguable that a taxpayer did not act willfully even if he perhaps *should* have been aware of the reporting requirements. *Hawkins* suggests that these arguments may be even stronger if there is no evidence of deception or concealment.

Conclusion

However much the IRS may be flummoxed, the Ninth Circuit came to the right conclusion. 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 he was not willful.

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[34]Charles P. Rettig, ''OVDP and Streamlined Procedures: Am I Non-Willful?'' *Journal of Tax Practice and Procedure* (Aug.-Sept. 2014).

[35]Andrew Velarde, ''Streamlined Program Non-Willful Certification Can Be Hazardous'' (July 25, 2014).

[36]*Spies v. United States*, 317 U.S. 492, 497 (1943) (''willful . . . is a word of many meanings, its construction often being influenced by its context'').

[37]Section 6672 (authorizing penalties for any person ''required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof'').

[38]*See, e.g.*, *United States v. Gephart*, 818 F.2d 469, 475 (6th Cir. 1987) (''It is generally held that one who is a responsible person follows the directions of a superior not to pay withholding taxes to the government at his peril'').

[39]Velarde, ''Practitioners Debate Fairness of Lack of OVDP Retroactivity,'' *Tax Notes*, Aug. 11, 2014, p. 669.

[40]*See, e.g.*, *United States v. McBride*, 908 F. Supp.2d 1186, 1204 (D. Utah 2012) (willfulness found based on taxpayer's signature on return and deliberate withholding of information from his accountant).

[41]31 U.S.C. section 5321(5)(B), (C).

[42]31 U.S.C. section 5321(5)(C), (D).

[43]31 U.S.C. section 5321(5)(C) (''In the case of any person willfully violating, or willfully causing any violation of . . .'').

[44]*See, e.g.*, *United States v. Zwerner*, No. 1:13-cv-22082 (S.D. Fla. 2014) (noting that summary judgment is inappropriate under both the government's view of willfulness as including reckless disregard, and taxpayer's view which would require a voluntary intentional violation of a known legal duty, but failing to choose a definition).

It is hard to see how excessive spending alone manifests a willful attempt to evade or defeat taxes. At the same time, tax evaders, big spenders, offshore account deniers, and others who may be applauding the fact that the IRS lost in *Hawkins* may be celebrating too soon. It is not yet clear whether the decision will affect willfulness analysis in other tax contexts.

Notably, there is no express requirement that the rules for bankruptcy dischargeability parallel jeopardy collection procedures. Even so, 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 those very same jeopardy collection rules.

It is even harder to draw a parallel to offshore account cases. The context is quite different, and the history, especially over the last five years, is rich and complex. Moreover, the statutory language for a willful failure to file FBARs does not include the same specific-intent language.

Arguably, when it comes to willfulness, context is crucial. And there is one significant parallel. The Ninth Circuit's analysis of willfulness was informed in part by the overriding purpose of the Bankruptcy Code. That underlying axiom is to ensure that honest debtors receive a fresh start.

This goal mirrors the offshore voluntary disclosure program. The OVDP is designed to encourage taxpayers to come forward with their foreign accounts, and the conclusiveness of a closing agreement provides a fresh start thereafter.

Indeed, now that the OVDP has such also-rans as the streamlined programs, arguably the fresh start analog of the OVDP's closing agreement is now even more akin to emerging from a bankruptcy discharge. It is at least arguable that an approach similar to that of the Ninth Circuit in *Hawkins* should apply.

Consumers and tax professionals are likely to agree with the government that tax evasion and failure to report foreign accounts are objectionable, no matter how the duality of spending and evading makes Drake feel. But the government must prove its case, and excessive penalties are no good either. In that sense, *Hawkins* suggests a balanced path forward in the law of willfulness in tax cases.