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The Element of Willfulness: A Defense for Tax Shelters?

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People are always asking me for free legal advice after finding out that I defend people in civil and criminal tax controversies. One of my most recent interrogations was conducted by an accountant at a highbrow cocktail party. Now I don't mind having a casual conversation about tax, but I try and steer clear of doling out legal advice to people who are already half in the bag and who are only going to remember half of what I tell them anyway. (By the way, I hear that a lawyer can be sued for giving out bad legal advice even when it's at a cocktail party. Therefore, when a prospective client is smashed, doesn't remember to provide all of the facts, and may only hear half of the answer, there is a greatly enhanced risk of a malpractice action.)

One of the topics of our conversation involved tax shelters. In the process, I remarked, ''You know, ignorance is a good excuse for the law.'' To which the accountant responded, ''I thought ignorance is *no* excuse for the law.'' We proceeded to discuss the interesting concept of how the government is trying to attack established tax shelter designers despite the fact that ignorance and complexity are both legally acceptable excuses for tax crimes. In doing so, we concluded that the government will have a heavy burden in attempting to prove the element of willfulness, which is one of the elements of a tax crime.

The IRS believes that some individuals and businesses have promoted certain tax shelters and encouraged individuals to participate in them as a way to avoid reporting large capital gains from unrelated transactions (talk about a party gone out of control). Any person, warns the IRS, who willfully conceals the amount of capital gains and losses in that way, or who willfully advises others regarding that type of concealment, may be guilty of criminal offenses.

However, if the government is going to have a fighting chance at landing any indictments involving criminal offenses by a promoter, it's going to have to figure out how to circumvent the case law that developed the definition of willfulness.

Criminal Investigation of KPMG's Tax Shelter Operations

KPMG is being investigated by the U.S. Attorney's Office in the Southern District of New York for some of its tax strategies. The investigation focuses on specific tax strategies (the IRS calls them shelters; KPMG calls them ''solutions'' or ''tax products'') known as the bond linked issue premium structure (BLIPS) strategy, the foreign leveraged investment program (FLIP), the offshore portfolio investment strategy (OPIS), and possibly the S corporation charitable contribution strategy (SC2).

BLIPS

KPMG pitched BLIPS as a tax-advantaged investment that would generate a large tax loss. The investor was told that in exchange for payments to KPMG, which were frequently in the millions, he would generate a tax loss of as much as 10 to 20 times the investment.

Three tax shelters — FLIP, OPIS, and BLIPS — are similar and function as ''loss generators,'' meaning they generate large paper losses that the purchaser of the product then uses to offset other income, thereby sheltering it from taxation. All three products have generated hundreds of millions of dollars in paper losses for taxpayers by using a series of complex orchestrated transactions involving shell corporations, structured finance, purported multimillion dollar loans, and deliberately obscure investments.

The BLIPS transactions required a bank to lend, on a nonrecourse basis, money to a shell corporation with few assets and no ongoing business. The so-called loan proceeds were instead deemed ''collateral'' for the ''loan'' itself under an ''overcollateralization'' provision that required the ''borrower'' to place 101 percent of the loan proceeds on deposit with the bank. The loan proceeds, serving as cash collateral, were then subject to severe investment restrictions and were closely monitored by the bank.

The end result was that only a small portion of the funds in each BLIPS transaction was ever placed at risk in legitimate investments. Also, the banks were empowered to unilaterally terminate a BLIPS loan under a variety of circumstances, including, for example, if the cash collateral fell below 101 percent. The banks and investment advisory firms knew that the BLIPS loan structure and investment restrictions made little economic sense apart from the client's tax objectives, which consisted primarily of generating huge paper losses for KPMG's clients who then used those losses to offset other income and shelter it from taxation.

BOSS

Another tax shelter that was widely marketed was called the bond and option sales strategy (BOSS). The IRS shut it down with Notice 99-59, 1999-52 IRB 761, *Doc*

1999-38713, 1999 TNT 237-1. The BOSS shelter involved an arrangement that applied the rules for corporate distributions of encumbered property to create artificially high basis in the corporate stock that would produce deductible losses on the later disposition of the stock by shareholders. There are now civil cases docketed in Tax Court involving the next evolution of that strategy, the son-of-BOSS shelters.

In Notice 2000-44, 2000-36 IRB 255, *Doc 2000-21236, 2000 TNT 157-7,* the IRS identified arrangements involving partnership interests that created artificially high basis in partnership interests, resulting in deductible losses on the later disposition of the partnership interests by the partners. In one version of the partnership variation of the shelter, a taxpayer borrowed at a premium and contributed the cash to a partnership, and the partnership assumed liability for the debt. For example, the taxpayer received $3,000 in cash under a loan agreement that provided an inflated stated rate of interest and a stated principal of only $2,000. The taxpayer contributed the $3,000 to a partnership and the partnership assumed the debt. The taxpayer then sold the partnership interest.

The partner took the position under sections 705(a)(2), 722, and 752(b) that its basis in its partnership interest was $1,000. The partner argued that the amount of the liability that the partnership had assumed under section 752(b) was $2,000, so that under section 705(a)(2), its basis in the partnership interest should be reduced to $1,000. The partner then sold the partnership interest for a nominal amount and claimed a $1,000 capital loss.

In another version, offsetting assets and liabilities were present but the taxpayer took the position that the partnership had not assumed any liability. The taxpayer purchased a call option and simultaneously wrote an offsetting call option. The taxpayer then contributed both options to a partnership. The partner took the position that its basis in the partnership interest was the same as its positive basis in the purchased call option, unreduced by the liability associated with the written call option. That is, the partner took the position that the partnership did not assume any liability when it took responsibility for the written call option. The partner used that artificially high basis to claim a capital loss on the sale of the partnership interest.

The IRS asserts that the purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of section 165. The purported losses from those transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes. The purported tax benefits from those transactions may also be subject to disallowance under other provisions of the code and regulations. In particular, the transactions may be subject to challenge under section 752, reg. section 1.701-2, or other antiabuse rules. Also, in the case of individuals, those transactions may be subject to challenge under section 165(c)(2).

If you are confused, imagine how a jury would feel if it had to analyze those shelters. The complexity of the transactions alone should be a viable defense to willfulness.

Willfulness: The Case Law

The general rule that ignorance of the law or a mistake of law is no defense to criminal prosecution is deeply rooted in the American legal system. See, for example, *United States v. Smith*, 18 U.S. 153 (1820); *Reynolds v. United States*, 98 U.S. 145 (1879). Based on the notion that the law is definite and knowable, under common law it was presumed that every person knew the law.

However, the proliferation of statutes and regulations has sometimes made it difficult for the average citizen to know and comprehend the extent of the duties and obligations imposed by the law, especially the tax law. Therefore, Congress has softened the effect of the common-law presumption by making specific intent to violate the law an element of some federal criminal tax offenses. As a result, more than half a century ago the Supreme Court interpreted the term ''willfully'' as used in federal criminal tax statutes as carving out an exception to the traditional rule.

The special treatment of criminal tax offenses is largely due to the complexity of the tax laws. In *United States v. Murdock*, 290 U.S. 389 (1933), the Court stated, ''Congress did not intend that a person, by reason of a bona fide misunderstanding as to his liability for the tax, as to his duty to make a return, or as to the adequacy of the records he maintained, should become a criminal by his mere failure to measure up to the prescribed standard of conduct.'' *Id.* at 396.

The Court held in *Murdock* that the defendant was entitled to a jury instruction as to whether he acted in good faith based on his actual knowledge. The Court further interpreted the term ''willfully'' generally to mean ''an act done with a bad purpose'' or with ''an evil motive.'' *Id.* at 394-95.

Subsequent decisions have refined that proposition. In *United States v. Bishop*, 412 U.S. 346 (1973), the Court described the term ''willfully'' as connoting ''a voluntary, intentional violation of a known legal duty.'' *Id.* at 360. *United States v. Pomponio*, 429 U.S. 10 (1976), dealt with several defendants who had been charged with willfully filing false tax returns. The jury was given an instruction on willfulness similar to the standard set forth in *Bishop*. However, the jury was also instructed that ''good motive alone is never a defense where the act done or omitted is a crime.'' *Pomponio* at 11. The defendants were convicted but the court of appeals reversed, holding that the latter instruction was improper because the statute requires a finding of bad purpose or evil motive. The court of appeals had assumed that an ''evil motive'' required something other than ''an intentional violation of a known legal duty.'' However, an additional instruction on good faith was unnecessary.

The standard for the statutory willfulness requirement is the ''voluntary, intentional violation of a known legal duty.'' However, a series of cases have added to that definition. One of those cases involved a complicated tax shelter.

United States v. Critzer

In *United States v. Critzer*, 498 F.2d 1160 (4th Cir. 1974), Amy Critzer, an Eastern Cherokee Indian, was convicted of willfully attempting to evade and defeat the federal income tax in violation of section 7201. She owned

businesses on land that was in the Eastern Cherokee Reservation and failed to report a portion of her income derived from the operation of her businesses. The Bureau of Indian Affairs advised her that she was not liable for the tax in question, although there had been no decisive ruling on the issue. The court of appeals reversed the district court, holding that Ms. Critzer could not be guilty of willfully evading the tax that different branches of the government could not even definitively agree she owed. More significantly, the Fourth Circuit concluded that the law had not provided any certainty about what Ms. Critzer was required to pay. It also held that the proper vehicle for deciding the matter was not a criminal prosecution.

United States v. Garber

In *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979), Dorothy Garber was indicted for willfully and knowingly attempting to evade a portion of her income tax liability for the years 1970, 1971, and 1972 by filing a false and fraudulent income tax return on behalf of herself and her husband. A jury found her innocent of the charges for 1970 and 1971 but convicted her under section 7201 for knowingly misstating her income on her 1972 tax return. The taxability of the money received by Ms. Garber presented a unique legal question. Sometime in the late 1960s, after the birth of her third child, Ms. Garber was told that her blood contained a rare antibody that is useful in the production of blood-group-typing serum. A manufacturer of diagnostic reagents used in clinical laboratories and blood banks had made the discovery, and in 1967 it induced her to enter into a contract for the sale of her blood plasma. With a technique called plasmapheresis, a pint of whole blood was extracted from her arm, the plasma was centrifugally separated, and the red cells were returned to her body.

In exchange for Ms. Garber's blood plasma, the biomedical company agreed to pay her for each plasma extraction on a sliding scale dependent on the strength of the plasma obtained. Because Ms. Garber's blood was so rare, and she was one of only two or three known persons in the world with the antibody, she was approached by other laboratories. By 1970, 1971, and 1972, the three years covered in the indictment, she was receiving substantial sums of money in exchange for her plasma. For two of those years she was selling her blood under separate contract to two other companies.

Ms. Garber claimed she did not have to report some of her payments as income for various reasons. One reason was that she didn't believe the process that returned the blood to her body resulted in a sale of anything. Eventually, the Fifth Circuit reversed her conviction, holding that the element of willfulness was lacking.

United States v. Dahlstrom

In *United States v. Dahlstrom*, 713 F.2d 1423 (9th Cir. 1983), the government attempted to bring a criminal prosecution against a shelter promoter. Five individuals were convicted of conspiracy to defraud the United States in violation of 18 U.S.C. section 371 and of aiding and abetting the preparation and filing of fraudulent income tax returns in violation of section 7206(2). All of those offenses were in connection with the defendants' advice regarding a tax shelter program. On appeal, the Ninth Circuit reversed the convictions because the government failed to prove that the defendants possessed the specific intent to violate section 7206(2) and because the law regarding the legality of the tax shelter program was unsettled.

(As noted above, some of the tax shelter programs promoted by KPMG are currently being litigated in the Tax Court. I hope those cases will settle the law regarding taxpayer investors' civil liabilities. It would seem that if the law is unsettled regarding those new shelters, as a matter of law it would not be possible to obtain a criminal conviction in connection with their promotion.)

In a nutshell, here's what Dahlstrom's shelter was all about. He would sell a taxpayer a membership in an organization that Dahlstrom had formed, the American Law Association (ALA). Members were entitled to receive instruction and materials regarding the tax shelter program at ALA seminars. Members attending those ALA seminars were charged fees ranging from $6,000 to $12,000. At those seminars, Dahlstrom instructed members on how to create foreign trust organizations (FTOs) to reduce their tax liabilities. The members were also provided with forms for setting up those trust organizations and documenting trust transactions. In addition, members received instruction on a ''taxpayer defense program'' that consisted of lawful actions a member could use in the event of an IRS audit. While the program did not include advice or assistance in preparing a member's income tax return, some of the appellants occasionally assisted a member in establishing his FTO by traveling to the designated country and executing the requisite trust documents on behalf of that member.

Members who implemented the ALA tax shelter program caused three trust organizations to be created in a foreign country by a citizen of that country. Typically, trust number one would be named trustee of trusts two and three, although the person implementing the FTOs retained complete control over all three trusts. That tax shelter program contemplated that trust number two would be treated as a nonresident alien (purely for tax purposes) and would be subject to tax on payments from the user of the program. To reduce trust two's tax liability, purchasers of the program had trust two make payments to trust three. Payments made to trust three would not represent taxable income because trust three would be a foreign entity receiving income from a foreign source. The final stage of the tax shelter program involved the return to the purchaser of some or all the money he paid to trust number two. To achieve that goal, a purchaser would have trust two borrow money from trust three and execute a demand note payable to trust three. Trust three would then transfer the demand note to the purchaser as a gift and the purchaser would demand and receive payment from trust two. That transfer was premised on section 102, which excludes gifts from gross income for income tax purposes, and section 2501, which provides a gift tax exemption for gifts of intangible property by a nonresident alien to a citizen of the United States.

To try to meet its burden of proof as to the defendants' willfulness, the government relied on three major arguments. First, the government asserted that the FTOs advocated by the ALA had no economic substance and were therefore blatant shams. Second, the government

argued that the ''taxpayer defense program'' could reasonably be found to be inconsistent with a belief in the legality of the tax shelter program. Finally, the government pointed to some statements made by one of the defendants to show guilty knowledge.

In support of its first contention, the government argued that the law was clear that economic realities of a transaction rather than form are controlling for tax purposes. Therefore, the government asserted that the defendants were well aware of the inherent illegality of the tax deductions that flowed from use of the ALA tax shelter program. The government, however, did not point to any cases that invalidated the FTOs used in this case. Moreover, the government's own expert witness testified that the trusts created through implementation of the ALA tax shelter program were valid legal entities.

The Ninth Circuit determined that even if it were to assume that the defendants were negligent in continuing to promote the ALA tax shelter program in light of the IRS's adverse position paper, the law is clear that degrees of negligence only give rise to civil penalties, citing *Bishop* at 360. It added that ''The criminal law concerns itself with willful violations of tax law,'' citing *United States v. Brooksby*, 668 F.2d at 1102, and that ''its purpose is not to penalize frank differences of opinion,'' citing *Bishop* at 361. The court was convinced that the legality of the tax shelter program advocated by the appellants was completely unsettled by any clearly relevant precedent on the dates alleged in the indictment. ''It is settled that when the law . . . is highly debatable, a defendant — actually or imputedly — lacks the requisite intent to violate it,'' citing *Critzer* at 1162. A criminal proceeding pursuant to section 7206, the court said, ''is an inappropriate vehicle for pioneering interpretations of tax law,'' citing *Garber* at 100.

Finally, the Ninth Circuit stated that even if the defendants knew that a taxpayer who actually performed the actions they advocated would be acting illegally, the First Amendment would require a further inquiry before a criminal penalty could be enforced. Only one of the defendants actually assisted in the preparation of an individual tax return, the others merely instructed an audience on how to set up a particular tax shelter. The Ninth Circuit noted that nothing should be clearer at this stage in the development of First Amendment jurisprudence than ''the principle that the constitutional guarantees of free speech and free press do not permit a State to forbid or proscribe advocacy . . . of law violation except where such advocacy is directed to inciting or producing imminent lawless action and is likely to incite or produce such action,'' citing *Bradenburg v. Ohio*, 395 U.S. 444, 447, 89 S. Ct. 1827, 23 L. Ed. 2d 430 (1969) (per curiam). Nothing in the court record indicated that the advocacy practiced by the defendants contemplated imminent lawless action. The court remarked that not even national security can justify criminalizing speech unless it fits within the narrow category described in *Bradenburg.*

United States v. Harris

In *United States v. Harris*, 942 F.2d 1125 (7th Cir. 1991), two sisters were convicted of willfully evading their income tax on money given to them by a friend. A wealthy widower partial to the company of young women befriended the Harris twins. The widower gave each sister more than half a million dollars over the course of several years. The widower died. The government alleged that the money was income. The sisters argued that the money was a gift. The Seventh Circuit reversed the convictions (and remanded with instructions to dismiss the indictments) because the government failed to show the defendants willfully failed to pay taxes on the money given to them by their friend.

Cheek v. United States

In the 1990s the Supreme Court weighed in on the definition of willfulness on multiple occasions. In *Cheek v. United States*, 498 U.S. 192 (1991), an American Airlines pilot said he honestly believed that he didn't have to report his wages as income. (He also was ''tax challenged'' and said the income tax was unconstitutional.) The district court instructed the jury that a good-faith misunderstanding of the tax laws was not a defense when the asserted beliefs were unreasonable.

The Supreme Court said that Mr. Cheek was entitled to a jury instruction stating that an honest good-faith belief that he wasn't violating the law is a defense to willfulness. (A belief that the income tax is unconstitutional is no defense at all.) Further, the good-faith belief is measured by a subjective standard. In other words, if the jury believed that Mr. Cheek had an honest good-faith belief that he was not violating the law, whether or not his beliefs would be considered objectively reasonable, there is no willfulness. The Court vacated and remanded the case because of the lack of a jury instruction on a good-faith misunderstanding of the tax law.

Ratzlaf v. United States

In *Ratzlaf v. United States*, 510 U.S. 135 (1994), the Supreme Court clarified the element of willfulness in a structuring case. One night in October 1988, Waldemar Ratzlaf ran up a debt of $160,000 playing blackjack at the High Sierra Casino in Reno, Nev. The casino gave him one week to pay. On the due date, Ratzlaf returned to the casino with $100,000 cash in hand. A casino official informed Ratzlaf that all transactions involving more than $10,000 in cash had to be reported to state and federal authorities. The official added that the casino could accept a cashier's check for the full amount due without triggering any reporting requirement.

The casino helpfully placed a limousine at Ratzlaf's disposal and assigned an employee to accompany him to banks in the vicinity. Informed that banks, too, are required to report cash transactions in excess of $10,000, Ratzlaf purchased cashier's checks, each for less than $10,000 and each from a different bank. He delivered the checks to the High Sierra Casino. As a result of that endeavor, Ratzlaf was charged with ''structuring transactions'' to evade the banks' obligation to report cash transactions exceeding $10,000; that conduct, the indictment alleged, violated 31 U.S.C. sections 5322(a) and 5324(3). The trial judge instructed the jury that the government had to prove the defendant's knowledge of the banks' reporting obligation and his attempt to evade that obligation, but it did not have to prove the defendant knew that structuring was unlawful. Ratzlaf was convicted, fined, and sentenced to prison. (Federal law requires banks and other financial institutions to file

reports with the Treasury secretary whenever they are involved in a cash transaction that exceeds $10,000.)

It is illegal to ''structure'' transactions — that is, to break up a single transaction above the reporting threshold into two or more separate transactions — for the purpose of evading a financial institution's reporting requirement. 31 U.S.C. section 5324. ''A person willfully violating'' this antistructuring provision is subject to criminal penalties. 31 U.S.C. section 5322. The case presented a question on which the circuit courts of appeal were divided: The Supreme Court held that the term ''willfulness'' required that a defendant ''willfully violated'' the antistructuring law, and the government must prove that the defendant acted with knowledge that his conduct was unlawful.

Bryan v. United States

In *Bryan v. United States*, 524 U.S. 184 (1998), Mr. Bryan was convicted of violating 18 U.S.C. section 924(a)(1)(D), which prohibits anyone from ''willfully'' violating, *inter alia*, section 922(a)(1)(A), which forbids dealing in firearms without a federal license. The evidence at the petitioner's trial for unlicensed dealing was adequate to prove that he was dealing in firearms and that he knew his conduct was unlawful, but there was no evidence that he was aware of the federal licensing requirement. The trial judge refused to instruct the jury that he could be convicted only if he knew of the federal licensing requirement, instructing instead that a person acts ''willfully'' if he acts with the bad purpose to disobey or disregard the law, but that he need not be aware of the specific law that his conduct may be violating. The Second Circuit affirmed, concluding that the instructions were proper and that the government had elicited ''ample proof'' that the defendant had acted willfully. The Supreme Court held that the term ''willfully'' in section 924(a)(1)(D) requires proof only that the defendant knew his conduct was unlawful, not that he also knew of the federal licensing requirement.

Any Crime Will Do

Recent cases have not significantly added to the definition of willfulness (for example, on May 24, 2004, the Supreme Court denied certiorari in *Anderson v. United States*, 353 F.3d 490 (6th Cir. 2003), *cert. denied* 124 S. Ct. 2402 (2004).

A tax crime can be complex and therefore difficult to prove. For the government to prove the element of willfulness, it must prove to the jury what was going on in the defendant's head when he committed the alleged crime. The government will be hard-pressed to convict a representative of KPMG for actually promoting a tax shelter. The outcome of *United States v. Dahlstrom* should have taught the government that it is difficult to obtain a tax conviction for illegally promoting a complex tax shelter involving unsettled law.

At the same time, I know many IRS special agents who are flexible when it comes to building a criminal case, and they will not hesitate to look for current criminal violations as well as past offenses. Recently, subjects of investigations have been doing a good job of committing new crimes, which carry just as harsh a sentence as the original crime being investigated. (For example, Martha Stewart and Frank Quattrone were convicted of obstruction of justice, among other things, because they said or did things to thwart federal investigations.)

It may be difficult for the government to prosecute KPMG or its representatives for promoting their complicated shelters. The complexity of their tax shelters will be used as a shield and a defense to willfulness. However, that doesn't mean the IRS and the Justice Department will not figure out how to close down the tax shelter party in other ways.