No. 14-_____

In The
Supreme Court of the United States

JAMES CHARLES VAUGHN,

Petitioner,

v.

UNITED STATES OF AMERICA,
INTERNAL REVENUE SERVICE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

The federal circuits have adopted inconsistent standards for denying debtors bankruptcy discharges for willfully attempting to evade or defeat a tax under 11 U.S.C. § 523(a)(1)(C), culminating in a recent split between the Ninth and other Circuits.

The question presented is: What is the minimum required culpability state for denying a bankruptcy debtor a discharge of a tax debt based on the debtor's participation in a disallowed tax shelter, and spending decisions in light of a known or potential tax debt? Is the standard:

- **negligence** (*i.e.,* the debtor should have known better than to participate in the tax shelter or spend money on something other than a present or potential future tax bill), per the analysis of several circuits including the Tenth Circuit in *Vaughn*;
- **specific intent** (*i.e.,* the debtor must specifically intend for his spending to defeat the IRS's ability to collect a tax debt), per the Ninth Circuit's analysis in *Hawkins*;
- the mental state of **knowingly** (*i.e.*, the debtor knows it is practically certain that his spending will put money beyond the reach of the IRS's collection efforts), in conformity with this Court's decisions equating willfulness with knowledge; or
- some other mental state?

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PETITION FOR WRIT OF CERTIORARI

James Charles Vaughn petitions this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit affirming the bankruptcy court's determination that his tax debt was not dischargeable in bankruptcy due to Vaughn's "willful evasion" under 11 U.S.C. § 523(a)(1)(C).

I. OPINIONS BELOW

The Colorado Bankruptcy Court's decision denying Vaughn a discharge is reported as *In re Vaughn*, 463 B.R. 531 (Bkr.D.Colo. 2011). App. 39. The District Court affirmed in an unpublished opinion. No. 12-cv-00060-MSK (3/29/2013). App. 24. The Tenth Circuit affirmed. *In re Vaughn*, 765 F.3d 1174 (10th Cir. 2014). App. 1.

II. JURISDICTION

The Tenth Circuit entered judgment August 26, 2014, and denied Vaughn's timely petition for rehearing *en banc* on October 20, 2014. App. 76. The Tenth Circuit stayed the mandate for this certiorari petition pursuant to F.R.A.P. 41(d)(2). App. 22.

Federal jurisdiction is proper pursuant to 28 U.S.C. §§ 151 (Bankruptcy Court); 1331 and 1334 (District Court); 1291 (Tenth Circuit); and 1254(1) (this Court).

III. CONSTITUTIONAL AND STATUTORY PROVISIONS

11 U.S.C. § 523(a)(1)(C) provides:

§ 523. Exceptions to discharge

(a) A discharge under . . . this title does not discharge an individual debtor from any debt –

(1) for a tax or a customs duty –

* * *

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax. . . .

IV. STATEMENT OF THE CASE

A. Facts

Debtor James Vaughn is a self-made businessman. Despite having little formal education beyond high school, Vaughn achieved success in several cable and communication companies. App. 2. In 1995, Vaughn founded and served as CEO of FrontierVision Partners, shepherding it from a start-up into a two-billion dollar cable television acquisition company. *Id.* FrontierVision used the national tax advisory firm KPMG as its outside accountant and tax firm, and also hired a former KPMG certified public accountant and senior tax manager as vice-president and treasurer. App. 41.

In 1999, Vaughn sold FrontierVision for about $2.1 billion, from which Vaughn received about $20 million in cash and $11 million in the purchasing company's stock. App. 39, 42.

Vaughn understood that this sale was a taxable event that would entail a large tax bill. Vaughn was no tax protester – he had always filed returns and paid his taxes. But for this $31 million taxable event, Vaughn was urged to seek specialized tax advice. Unfortunately for Vaughn, he followed the recommendation of the former KPMG senior tax manager to let KPMG advise him about his tax situation. App. 42.

KPMG sold Vaughn on a tax strategy called BLIPS – one of many "Son of BOSS" basis-shifting tax shelters that KPMG heavily promoted in the 1990s. App. 3. These shelters used accounting maneuvers to generate losses to offset capital gains from the sale of a business.[1] The complex details of this now-discredited tax avoidance strategy are discussed in the record, but are not relevant for this petition.

Vaughn was hardly alone in following KPMG's tax advice: some 1,800 wealthy taxpayers participated in KPMG's Son of BOSS shelters in the 1990s; and the tax on Vaughn's $31 million capital gain was

[1] *See* http://en.wikipedia.org/wiki/Son_of_Boss (all websites visited 1/19/2015).

a tiny part of the $11 billion in tax losses that the IRS would eventually disallow.[2]

KPMG's promotion of the BLIPS tax shelter included opinion letters warning that the shelter might be flagged by the IRS and audited, followed by assurances that the shelter would "more likely than not" pass IRS muster. App. 5, 48. Vaughn could have paid the tax with the FrontierVision sale proceeds, but given KPMG's representation that the shelter was legitimate, Vaughn viewed the situation "as a choice between paying $9 million of taxes currently or claiming the benefits of [the BLIPS] losses and paying $3 million currently with some risk of paying more taxes later," if the tax shelter was disallowed by the IRS. App. 4. Vaughn therefore chose to participate in the KPMG-promoted shelter. He reported all $31 million of income from the FrontierVision sale on his 1999 tax return, and offset that capital gain with comparable losses from the tax shelter. App. 5.

Nearly a year after Vaughn filed his 1999 tax return, he learned from KPMG that the IRS had issued Internal Revenue Bulletin Notice 2000-44 warning that it was scrutinizing basis-shifting transactions like BLIPS. App. 6.

In July 2001, Vaughn suffered the first of two major hits to his wealth when his first wife divorced

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[2] *See* http://www.irs.gov/uac/KPMG-to-Pay-$456-Million-for-Criminal-Violations; http://www.irs.gov/uac/IRS-Collects-$3.2-Billion-from-Son-of-Boss;-Final-Figure-Should-Top-$3.5-Billion.

him. App. 7. Under the asset division, Cindy Vaughn took the marital residence, five luxury cars, and half of the couple's $18 million brokerage account, leaving Vaughn with about $9 million in the brokerage account, a townhome, a car, and other personal property. *Id.*

Around this time (2001), Vaughn became involved with his soon-to-be second wife, Kathy St. Onge. Vaughn bought St. Onge a $1.7 million house shortly before they married in October 2001. App. 7. Vaughn also discussed establishing a trust fund for his future step-daughter, similar to the trust funds he had previously established for his own children with his first wife. Vaughn began working with his lawyer on the trust fund shortly after the October 2001 marriage, and funded it with $1.5 million in March 2002. App. 8.

In February 2002, as Vaughn received the trust documents for his step-daughter's trust fund, KPMG began advising its clients involved in Son of BOSS transactions to voluntarily disclose their participation to the IRS, since KPMG would soon be compelled to provide the IRS with its client lists, and voluntary disclosure would allow KPMG clients to participate in a penalty mitigation program. App. 8.[3] Vaughn's voluntary disclosure in March 2002 coincided with the date his step-daughter's trust funded, although

[3] *See* http://www.irs.gov/uac/IRS-Collects-$3.2-Billion-from-Son-of-Boss;-Final-Figure-Should-Top-$3.5-Billion.

Vaughn had begun work on establishing that trust several months earlier. *Id*.

In May 2002, the IRS first requested to meet with Vaughn about his 1999 tax return. At this time, Vaughn not only had KPMG's opinion letter that its BLIPS transaction would probably pass an audit, but KPMG was still standing behind its tax advice.[4] Throughout 2002, Vaughn and his new wife St. Onge lived like the modest millionaires they were: they spent money on luxuries such as home decoration and jewelry; and they sometimes wrote checks to cash in amounts commensurate with their routine spending on the order of about $10,000 per month. App. 9, 27-28.

In early 2003 – still before the IRS disallowed the KPMG tax shelter or assessed a tax – Vaughn's wealth took a second major hit when he and St. Onge separated and then divorced. In addition to the house Vaughn had bought St. Onge during their courtship, St. Onge took $3.5 million of the couple's brokerage account, leaving Vaughn with the lesser amount remaining in the account, the townhome and two cars. App. 9.

Then the tax bill finally came. In June 2004, the IRS completed its audit, disallowed the BLIPS

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[4] It was not until 2005 that KPMG admitted criminal wrongdoing and paid almost a half billion dollars in fines to the IRS. *See* http://www.irs.gov/uac/KPMG-to-Pay-$456-Million-for-Criminal-Violations.

deduction, and sent Vaughn a notice of tax deficiency for $8.6 million. App. 10. While Vaughn could have paid this tax bill with the proceeds of his FrontierVision sale (as he intended to do if necessary when he decided to participate in the tax shelter in 1999, App. 4), the two divorces in quick succession had nearly cleaned him out. Vaughn no longer had $8.6 million on hand, and was therefore unable to pay his tax bill in full in order to participate in the IRS's settlement initiative. App. 52-53.

In 2005, KPMG admitted criminal wrongdoing and several of its top tax partners involved in Son of BOSS transactions faced serious criminal charges.[5] The thousands of KPMG clients caught up in Son of BOSS tax shelters have generated numerous lawsuits, in addition to this one.[6]

Unlike some others, Vaughn did not contest the IRS's disallowance of his KPMG tax loss and resulting tax deficiency.[7] But since Vaughn no longer had

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[5] http://www.irs.gov/uac/KPMG-to-Pay-$456-Million-for-Criminal-Violations.

[6] *See, e.g.*, *Klamath Strategic Inv. Fund, LLC v. United States*, 568 F.3d 537 (5th Cir. 2009); *NPR Investments, L.L.C. ex rel. Roach v. United States*, 740 F.3d 998 (5th Cir. 2014); *American Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009); *Hawkins v. Franchise Tax Board*, No. 11-16276 (9th Cir. 2014) (petition for rehearing pending).

[7] *Compare Blum v. Commissioner*, 737 F.3d 1303, 1318 (10th Cir. 2013) (taxpayer stood by Son of BOSS tax shelter, lost, and was assessed a negligence penalty; appellate court upheld the

(Continued on following page)

enough money to pay his massive tax deficiency, he declared bankruptcy in 2006.

The IRS was Vaughn's only creditor, claiming $14 million: the roughly $9 million principal, plus interest. App. 10-11. All of Vaughn's remaining wealth went into his bankruptcy estate, and Vaughn continued to try to grow his latest wireless-related business in hopes of securing a sale and payoff like he scored with FrontierVision, to enable him to pay off his tax debt and move on. Unfortunately, Vaughn has so far not enjoyed a comparable repeat business success, although he has managed to significantly increase the value of his bankruptcy estate as a debtor in possession – *i.e.,* Vaughn has been effectively working for the IRS for the past several years.

B. Procedural History

Vaughn initiated this adversary proceeding to determine the dischargeability of his tax debt. The IRS challenged Vaughn's right to a discharge under 11 U.S.C. § 523(a)(1)(C), arguing that Vaughn's 1999 tax return was fraudulent because it included the KPMG-generated losses, and that Vaughn's lavish spending before he was assessed constituted a willful attempt to evade or defeat his tax obligation. The Bankruptcy Court held a trial that developed the

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penalty, describing taxpayer's participation as negligent while describing KPMG's conduct as "nefarious").

details of Vaughn's spending, such as buying a house for his fiancée in 2001.

The Bankruptcy Court ruled that Vaughn's 1999 tax return, though timely filed and listing all of his income, was *fraudulent* because it included losses based on the fully disclosed KPMG tax shelter. The Bankruptcy Court also ruled that Vaughn had willfully attempted to evade or defeat his tax obligation by living large while he knew or should have known that the IRS would disallow his tax shelter and he would therefore face a large tax bill in the future. App. 67-74. The Bankruptcy Court's analysis did not consider how Vaughn's two divorces occurred *before* Vaughn was assessed, and their impact on his ability to pay the deficiency. The Bankruptcy Court noted only Vaughn's first divorce (not his second), and commented that after having lost half his wealth in that first divorce Vaughn should have known to save his remaining wealth to cover a possible future tax bill if the IRS audited him and disallowed the KPMG deduction. App. 72.

The District Court affirmed based only on the willful evasion finding, not the fraudulent return finding, again predicated on Vaughn's spending *before* he was assessed. The District Court deliberately avoided addressing whether a tax return that discloses all the taxpayer's income and deductions could be deemed fraudulent. App. 29-30.

The Tenth Circuit also affirmed the willful evasion determination based on Vaughn's pre-assessment

spending. App. 16. Like the lower courts, the Tenth Circuit never considered how Vaughn's inability to pay the 2004 tax assessment stemmed principally from his 2001 and 2003 divorces. The Tenth Circuit acknowledged that all of Vaughn's supposedly culpable spending occurred before he was ever assessed, but it held that Vaughn's pre-assessment spending could be deemed evasive because failing to file a tax return is considered evasive, and that conduct necessarily occurs prior to any tax assessment. App. 18, citing three cases basing evasion on failure to file returns.

The Tenth Circuit applied the culpability standard for willful tax evasion developed by other circuits:

1) the debtor had a duty under the law;

2) the debtor knew he had the duty; and

3) the debtor voluntarily and intentionally violated the duty.

App. 15. The Tenth Circuit never defined the "duty" that Vaughn had knowingly and intentionally violated: A duty to pay taxes? A duty to reject tax shelters that the taxpayer should have foreseen would be disallowed by the IRS, even if they were endorsed by a top accounting firm like KPMG? A duty to save money for a possible future tax assessment? A duty to avoid losing one's wealth through divorces so it will be available to the IRS to satisfy a future assessment? The Tenth Circuit's decision effectively faulted

Vaughn and denied him a discharge for all of these reasons by holding that Vaughn's spending constituted tax evasion, even though all the supposedly evasive spending had occurred:

- before Vaughn was audited and assessed;
- while Vaughn reasonably believed he would probably not be assessed; and
- while Vaughn still had substantial assets to pay a future tax assessment, should there be one.

C. The Ninth Circuit recognizes a circuit split in *Hawkins*.

While Vaughn's bankruptcy was being litigated in the Tenth Circuit, a functionally identical case was proceeding in the Ninth Circuit, culminating in an opinion that rejects the Tenth Circuit's approach and recognizes a circuit split. *Hawkins v. Franchise Tax Board*, No. 11-16276 (9th Cir. 2014) (petition for rehearing pending). App. 78. In *Hawkins*, the Ninth Circuit recognized that willful evasion cannot be based on participating in a tax strategy endorsed by a premier tax firm like KPMG; and it also held that willful evasion might be premised on the debtor's lavish spending only where the debtor knows he owes a tax debt, knows he cannot pay that debt, and the debtor *specifically intends* his spending to defeat the IRS's collection efforts. App. 79.

Hawkins's tax situation is functionally identical to Vaughn's. Like Vaughn, Hawkins became a millionaire

through sale of the high-tech business he founded. App. 80-81. Like Vaughn, Hawkins could have paid taxes on his capital gains with the proceeds of the sale, but he decided (unfortunately, in hindsight) to participate in a similar KPMG tax shelter. App. 81. Like Vaughn, KPMG gave Hawkins an opinion letter that this tax shelter might be challenged by the IRS, but was "more likely than not" to pass muster. *Hawkins v. Franchise Tax Board*, 430 B.R. 225, 233 (Bkr.N.D.Cal. 2010). Like Vaughn, Hawkins's considerable wealth took a huge dive around the same time that the IRS decided to challenge the KPMG tax shelter. App. 82-83.[8] Like Vaughn, Hawkins filed for bankruptcy, seeking to discharge his tax debt to the IRS and obtain a fresh start. App. 83. And like Vaughn, the IRS argued that Hawkins's tax debt was not dischargeable under 11 U.S.C. § 523(a)(1)(C) because: (1) listing a KPMG tax-shelter loss made his return fraudulent; and (2) he continued to live large despite knowledge of his tax debt. App. 84.

The Ninth Circuit took a markedly different approach to willful evasion than the Tenth Circuit did in this case. The Ninth Circuit courts rejected the IRS's position that a tax return could be rendered fraudulent by including a deduction approved by a

[8] Hawkins's wealth evaporated due to a downturn in his current high-tech company's fortunes. Vaughn also lost some wealth in the economic downturn, but he was largely cleaned out by his two divorces in quick succession.

premier tax firm like KPMG. 430 B.R. at 233.[9] The bankruptcy court instead found willful evasion based on Hawkins's lavish spending after Hawkins had been audited and assessed a tax debt, and he knew he was insolvent and unable to pay that tax bill. *Id.* at 234-38.

On appeal, the Ninth Circuit allowed that lavish spending by an insolvent debtor might constitute willful evasion, but ruled that the mental state of "willful" required *specific intent* to evade taxes. App. 85-94. The Ninth Circuit noted that nearly all debtors end up in bankruptcy because they spend beyond their means and are thus unable to pay their debts. To establish willful evasion, the IRS must prove that the debtor did more than intentionally spend money on something other than a known tax debt. App. 92-93. Rather, the debtor must specifically intend that his spending defeat the IRS's ability to collect the debtor's tax debt. The general approach of other circuits elevated commonplace profligacy (which underlies most bankruptcies but does not bar a discharge and fresh start) to willful evasion. *Id.* The Ninth Circuit opinion recognized its departure from its sister circuits, App. 92; and the dissent expressly objected to the majority's decision to create a circuit split. App. 96.

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[9] The IRS tried to revive the fraudulent return theory in its appellate briefs, but the Ninth Circuit rejected that argument without addressing it in its opinion.

V. REASONS FOR GRANTING THE PETITION

You must not act unjustly when deciding a case. Do not be partial to the poor or give preference to the rich; judge your neighbor fairly.

Leviticus 19:15 (2004 Holman Bible Publishers translation).

EQUAL JUSTICE UNDER LAW

Engraved on the main entrance to the Supreme Court.

A. Introduction

The Ninth Circuit panel opened its *Hawkins* opinion with F. Scott Fitzgerald's famous observation about how the rich "are different from you and me." App. 79. When it comes to discharging tax debts in bankruptcy, the rich are indeed treated differently: they are not judged preferentially, but harshly. They are grasshoppers who fritter away their wealth on luxuries and therefore cannot pay their taxes; we are the ants who sacrifice to satisfy our tax obligations, and are now expected to forgive these once-wealthy and irresponsible grasshoppers through a bankruptcy discharge. Debtors like Hawkins and Vaughn encounter judicial hostility when they seek to discharge their tax debts because Aesop teaches us that the rich don't deserve our forgiveness. App. 96 (*Hawkins* dissent, accusing majority of "turn[ing] a blind eye to the shenanigans of the rich.").

Aesop's morality tale is grounded in evolutionary biology.[10] It is only human nature to want to deny a once-wealthy and profligate debtor a discharge, especially when it comes to tax obligations that responsible taxpayers must effectively cover. Similarly situated poor debtors, by contrast, are easily forgiven. *E.g., In re Waterman*, 2012 WL 2255002 *7 (Bkr.S.D. Iowa) (characterizing non-wealthy debtor's discretionary spending in the face of known tax debt as "reasonable and modest").

So far, only two judges of the Ninth Circuit have been willing and able to set aside their natural, visceral response and analyze a once-wealthy debtor's conduct with the neutrality and uniformity that the federal bankruptcy laws require. *See* App. 92 ("As to discharge of debts, bankruptcy law must apply equally to the rich and poor alike, fulfilling the Constitution's requirement that Congress establish 'uniform laws on the subject of bankruptcies throughout the United States.' U.S. Const., art. I, § 8, cl. 4.").

The Ninth Circuit's decision to require specific intent, however, may raise problems of its own. Specific

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[10] Primates have a visceral reaction to and seek retribution against any member of their social group who tries to avoid paying his fair share. *See*, *e.g.*, Brosnan and de Waal, "Evolution of Responses to (Un)fairness," Science Magazine (9/18/2014) http://www.sciencemag.org/content/early/2014/09/17/science.1251776. This is why corporations that lower their taxes through offshore inversions are widely vilified, even though the tax strategy is perfectly legal.

intent (*i.e.,* "purposeful" conduct under the Model Penal Code's mental state hierarchy) certainly satisfies the willfulness requirement of section 523(a)(1)(C), per its plain language as developed by this Court. It is possible that "knowing" conduct (the second highest mental state in the Model Penal Code's hierarchy) would also suffice. That is, this Court's precedents might support a determination that a debtor willfully defeats a tax when he knows he owes a tax debt, and spends his money on luxuries with the knowledge that his spending is practically certain to render him unable to pay his tax debt.

But negligence does not satisfy section 523(a)(1)(C)'s willfulness requirement. In Vaughn's case, as in other cases, judges indulge their natural, visceral desire to punish once-wealthy and profligate debtors by denying them a bankruptcy discharge for conduct that was negligent: *e.g.,* ignoring tax bills, or failing to save for a future potential tax bill. Negligent conduct, however, does not bar a bankruptcy discharge. *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998) (willfulness under section 523(a)(6) is the mental state required for intentional torts, not for negligent or reckless acts; hence debt for medical malpractice judgment held dischargeable because it was premised on negligent or reckless conduct, not fraudulent or intentionally tortious conduct); App. 87; *accord In re Markowitz*, 190 F.3d 455, 465 n.10 (6th Cir. 1999) ("the mere fact that [the debtor] should have known his decisions and actions put [the creditor] at risk is also insufficient to establish a willful and malicious injury").

A review of willful evasion decisions confirms that once-wealthy debtors are sometimes treated harshly because of their former wealth, and often improperly denied a bankruptcy discharge for conduct that might be negligent but is not willful. The cases purport to find willfulness simply because the debtor spent money on himself instead of the IRS, without regard to the debtor's financial circumstances during that spending, such as the debtor's knowledge of an existing or potential tax debt, and how the debtor's spending actually impacted his ability to pay that debt. *See Spies v. United States*, 317 U.S. 492, 498 (1943) (willful evasion requires some sort of "evil motive and want of justification **in view of all the financial circumstances of the taxpayer**.") (emphasis added).

Vaughn is probably the most extreme case of treating mere negligence as willfulness. When Vaughn bought his fiancée a house and established a trust fund for his soon-to-be step-daughter (2001-2002), he did not owe a tax; he didn't know whether he would; and he reasonably believed that he wouldn't because top-tier tax firm KPMG had assured him that the shelter was more likely than not to pass IRS muster. And even if KPMG's advice was wrong, Vaughn had money on hand to pay a possible future tax assessment. Vaughn then had the misfortune of being cleaned out by a second divorce (2003) *before* the IRS disallowed his KPMG-endorsed tax shelter and assessed a tax (2004). The Tenth Circuit courts characterized Vaughn's ordinary pre-assessment spending (ordinary for the modest millionaire that he was) as

willful tax evasion by ignoring the above facts and chronology, faulting Vaughn for spending when he "should have known" that his KPMG-endorsed tax shelter would be disallowed, and that he should be saving his money to pay a future tax bill. App. 16 (Vaughn spent money on himself, his fiancée and future step-daughter "as if there would be no additional tax to pay."), quoting Bankruptcy Court opinion, App. 72. In other words, Vaughn was a grasshopper who sang when he should have saved. Such negligent conduct falls far short of section 523(a)(1)(C)'s willfulness requirement for denial of a discharge.[11]

Other circuits similarly punish once-wealthy debtors by treating their negligence as willful tax evasion in order to deny them a discharge. These cases are now in a split with the Ninth Circuit's specific intent requirement in *Hawkins*. This Court should grant certiorari to set a correct and uniform standard for denying debtors a discharge under section 523(a)(1)(C) for willfully evading or defeating a tax.[12]

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[11] The Bankruptcy Court even relied on a negligence penalty tax case as authority. App. 74, citing *Goldman v. Commissioner*, 39 F.3d 402, 408 (2d Cir. 1994) (upholding negligence penalty for tax underpayment based on disallowed tax shelter, where taxpayer should have known better than to rely on conflicted tax advisor).

[12] As of this certiorari petition, the IRS's petition for *en banc* reconsideration is pending in *Hawkins*. But even if the Ninth Circuit rehears and abandons its specific intent standard, the

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B. Plain language of section 523(a)(1)(C), and its origin.

Statutory interpretation starts with the statute's plain language, and how that language functions in the context of the statute as a whole. *E.g., Robinson v. Shell Oil Co.*, 519 U.S. 337, 340 (1997). Section 523(a)(1)(C) denies a bankruptcy discharge for tax debts "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." This case focuses on the second prong.

Dictionaries define "evasion" as to escape, elude or avoid, especially by cleverness, trickery, dexterity or stratagem; and "defeat" as to overcome, prevail over or vanquish. To evade or defeat a tax thus requires intentional conduct – something that all the circuits agree upon. *E.g.,* App. 15, 92.

The structure of section 523(a)(1), addressing discharge of tax debts, confirms that willfully evading or defeating requires more than failing to file a return, or pay a tax debt. Subsection 523(a)(1)(B) excepts from discharge taxes for which the debtor filed no return, or filed a late return before declaring bankruptcy. Likewise, filing a fraudulent return

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cases are still in disarray and in need of review and correction by this Court.

cannot be willful evasion because the first prong of section 523(a)(1)(C) addresses this conduct.[13]

More context is provided by parallel criminal provisions in the Internal Revenue Code. The provision criminalizing willful tax evasion as a felony has language functionally identical to section 523(a)(1)(C):

> Any person who **willfully** attempts in any manner to **evade or defeat any tax** imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony. . . .

26 U.S.C. § 7201 (emphases added). Contrast this felony statute with neighboring Internal Revenue Code section 7203, which makes failure to file a tax return or pay one's taxes a *misdemeanor*.[14]

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[13] The Bankruptcy Court erroneously held that Vaughn's 1999 return was fraudulent even though it disclosed all of his income from the FrontierVision sale, and disclosed the KPMG-approved tax shelter. The Bankruptcy Court found fraud because Vaughn *should have known* that the IRS would reject the shelter. App. 56, 59, 62, 66. As discussed, that's negligence, not fraud. The District Court recognized this error and affirmed willful evasion based only on Vaughn's spending, App. 29-30; and the Tenth Circuit did likewise. The erroneous fraud ruling is therefore no longer at issue here. But the Bankruptcy Court's eagerness to find *fraud* in what might have been negligence at worst shows how strongly human nature can dispose even a sophisticated federal judge against a once-wealthy debtor who seeks to discharge a tax debt.

[14] The intervening section 7202 makes failure to collect and pay over payroll withholding taxes a felony. Because the federal

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Both sections 7201 and 7203 of the Internal Revenue Code were on the books when Congress enacted Bankruptcy Code section 523, as part of the 1978 Bankruptcy Act, Pub. L. No. 95-598, Sec. 523; 92 Stat. 2549, 2590 (1978). The Court must therefore construe Bankruptcy Code section 523(a)(1)(C) *in pari materia* with Internal Revenue Code sections 7201 and 7203. *E.g., Molzof v. United States*, 502 U.S. 301, 307-08 (1992); *Morissette v. United States*, 342 U.S. 246, 263 (1952). As a result, a failure or even refusal to pay one's taxes, or failure or refusal to file a return, is not willfully evading or defeating a tax – the Internal Revenue Code defines failure or refusal to pay or file as a lesser crime than felony evasion, and only conduct constituting felony evasion results in denial of a bankruptcy discharge. The circuits, however, disagree about this simple and compelling analysis. *Compare In re Haas*, 48 F.3d 1153, 1158 (11th Cir. 1995) (debtor filed accurate returns but paid business and personal debts instead of taxes due before declaring bankruptcy; the Eleventh Circuit construed section 523(a)(1)(C) *in pari materia* with section 7201 to hold that failure to pay taxes was not evasion) *with In re Bruner*, 55 F.3d 195, 199-200 (5th Cir. 1995) (rejecting analysis of *Haas* and holding that intentional nonpayment of taxes, which would not satisfy section 7201, was nonetheless sufficient to deny the debtor a discharge).

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government runs largely on withheld payroll taxes, violations of this "trust fund" statute are *sui generis* and treated differently.

This Court's leading section 7201 case confirms that the Fifth Circuit is wrong on this issue. In *Spies v. United States*, this Court held that willful evasion under section 7201 could not be established by willful failure to file a return, or willful failure to pay a tax, or even both together, since both are violations of the misdemeanor statute, section 7203. 317 U.S. 492, 498-99 (1943). Rather, willful evasion required some sort of "evil motive and want of justification in view of all the financial circumstances of the taxpayer." *Id.* at 498. The Court offered examples of willfully evasive conduct: "keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal." *Id.* at 499.

C. Circuit decisions ignore statutory language and Supreme Court authority to improperly deny discharges of tax debts to once-wealthy debtors.

The circuits are in agreement that section 523(a)(1)(C), like all discharge exceptions, must be strictly construed in favor of the debtor. *E.g., United States v. Storey*, 640 F.3d 739, 743 (6th Cir. 2011); *In re Fegeley*, 118 F.3d 979, 983 (3d Cir. 1997); *Dalton v. I.R.S.*, 77 F.3d 1297, 1300 (10th Cir. 1996); *accord Local Loan Co. v. Hunt*, 292 U.S. 234, 244-45 (1934).

But that is about all the circuits agree on when it comes to their varying constructions of section 523(a)(1)(C).

Two categories of section 523(a)(1)(C) cases stand out as wrongly decided: failure to file return and pay cases, and lavish living cases. While *Vaughn* and *Hawkins* are lavish living cases, the failure-to-file-return cases are equally in need of correction; and they also illustrate how the natural, visceral human hostility to once-wealthy debtors seeking discharge can lead even sophisticated federal judges to err.

1. Failing to file a tax return or pay taxes is not willful evasion.

Some circuits follow, or purport to follow, the Eleventh Circuit's holding in *Haas* that nonpayment does not amount to willful evasion. *E.g., Storey*, 640 F.3d at 745 (rejecting IRS's argument for willful evasion based on nonpayment alone); *In re Birkenstock*, 87 F.3d 947, 951 (7th Cir. 1996) ("nonpayment of tax alone is not sufficient to bar discharge of a tax liability").

At the same time, circuit courts routinely deny discharges to debtors who fail to file returns in addition to failing to pay taxes. A good example is *In re Fretz*, 244 F.3d 1323 (11th Cir. 2001). There, an alcoholic ER doctor stopped filing returns and paying taxes for years, and eventually pled guilty to a criminal charge of willful failure to file a tax return, in violation of Internal Revenue Code section 7203

(the misdemeanor provision, not the felony provision with identical language to Bankruptcy Code section 523(a)(1)(C)). *Id.* at 1325. The Eleventh Circuit nonetheless held that the "debtor's intentional failure to file tax returns and to pay taxes owed" constituted willful evasion under the Bankruptcy Code section 523(a)(1)(C). *Id.* at 1324.[15] The Eleventh Circuit summarized its reasoning with classic grasshopper-versus-ant antipathy for a wealthy debtor who should not be allowed to dodge his fair share of the national tax burden:

> As a practicing emergency room physician, [Dr. Fretz] had the means to pay his taxes, and he had the ability either to file his tax returns himself or to engage an accountant to file the returns for him. Put bluntly, someone who can control his drinking enough to perform medical procedures during twelve- to twenty-four hour shifts in an emergency room over a period of years, can control his drinking enough to file tax returns and pay taxes during that same period. Instead of doing that, as Dr. Fretz himself put it, he "just totally ignored" his tax responsibilities.

Id. at 1331.

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[15] The IRS could not invoke section 523(a)(1)(B) to deny Dr. Fretz a discharge because he filed his bankruptcy petition more than two years after he belatedly filed his tax returns. 244 F.3d at 1325 (Fretz filed a decade's worth of past-due returns in 1994, then declared bankruptcy in 1997).

While this holding may feel right morally, it is patently wrong in its interpretation of section 523(a)(1)(C). Ignoring one's tax responsibilities is negligence, not willful evasion. The Eleventh Circuit had before it the stark juxtaposition of Internal Revenue Code section 7203 which punishes the failure to pay a tax *or file a tax return* as a misdemeanor, and section 7201, the felony statute that uses language identical to Bankruptcy Code section 523(a)(1)(C). Because failure to file returns amounts to the misdemeanor rather than the felony offense, it cannot be a sufficient basis for denying a discharge.

The Eleventh Circuit also quoted this Court's decision in *Spies*, but selectively focused on *Spies*' language declining to delimit what constitutes evasion, while ignoring *Spies*' more applicable language about evasion requiring an evil motive, and examples of conduct that might be deemed evasive. *Fretz*, 244 F.3d at 1327, quoting *Spies*, 317 U.S. at 499. Yet *Spies* makes abundantly clear that simply "ignoring" one's tax obligations, as Dr. Fretz did, is not willful evasion. *Id.* at 498-99.

Other circuits similarly punish a failure to file returns by denying a bankruptcy discharge, despite the plain language of the statutory scheme. *See In re Toti*, 24 F.3d 806, 809 (6th Cir. 1994) ("[F]ailure to file a tax return and failure to pay a tax fall within the definition in § 523(a)(1)(C) of a willful attempt to evade or defeat a tax liability."); *Fegeley*, 118 F.3d at 983 (debtor denied discharge based on failure to file returns and pay taxes, which resulted in a guilty plea

to violating Internal Revenue Code § 7203; "[A]ffirmative conduct by a debtor designed to evade or defeat a tax is not required"); App. 18 (describing failure to file a return as willful evasion).

The language of some cases even suggests that nonpayment of taxes alone is a sufficient basis for denying a discharge. *United States v. Stanley*, 2014 WL 6997518 *4 (5th Cir.) ("Although nonpayment does not suffice on its own, a knowing and deliberate nonpayment provides the basis for determining that the tax debt is non-dischargeable."); *In re Gardner*, 360 F.3d 551, 557 (6th Cir. 2004) ("acts of omission, such as failure to file returns and failure to pay taxes" render tax debt nondischargeable); *Storey,* 640 F.3d at 744 n.2 (discussing Sixth Circuit's disagreement with Eleventh Circuit's holding in *Haas* that nonpayment alone does not bar discharge).

These failure-to-file-and-pay cases are all contrary to the plain language of section 523(a)(1)(C), as that language was interpreted by this Court in *Spies*.

2. Living lavishly instead of paying a tax debt *might* constitute willful defeat of a tax.

Another category of wrongly decided section 523(a)(1)(C) cases focuses on the debtor's lavish living in the face of unpaid tax obligations. These living large cases purport to address both conduct and intent elements, *e.g.,* App. 12; but the cases are often

frustratingly vague about critical details of the debtor's conduct and intent. The conduct is necessarily the debtor's spending money so as to put it beyond the reach of the IRS's considerable collection powers. The intent requirement is consistently described as the intentional violation of a known duty. *E.g.,* App. 15 (mental state proven by evidence that "1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty."). All the circuits use this formula. *E.g., In re Jacobs*, 490 F.3d 913, 921 (11th Cir. 2007); *Gardner*, 360 F.3d at 558; *Fegeley*, 118 F.3d at 984.

This formula is vague because it leaves the duty undefined. Duty to do what? We all have a duty to file returns and pay our taxes, but, as previously demonstrated, the failure to do so is illegal but not willful evasion. Suppose a taxpayer doesn't owe a tax, but has only taken a deduction that might be disallowed and result in a future tax assessment? Can that taxpayer spend his money as he chooses, or does he have a duty to save it for the IRS just in case his deduction is disallowed? What if the debtor has the wealth to pay a known or potential tax debt, and therefore spends as he chooses, but then a later financial downturn wipes him out, rendering him a debtor seeking discharge in bankruptcy? In both of these scenarios, the debtor's spending is innocent or at worst negligent, but it is not willful because there is no evil motive or want of justification in light of all the debtor's financial circumstances. *Spies*, 317 U.S. at 498. Yet

cases punish such innocent or negligent spending by denying the once-wealthy debtor a bankruptcy discharge.

a. The debtor must know that he owes a tax.

Knowledge that a tax is owed is a necessary predicate for willfully defeating that tax, in light of *Spies*' requirement that the debtor have an evil motive, and lack justification for his failure to pay in light of all his financial circumstances. *Accord Jacobs*, 490 F.3d at 926 (debtor's "large discretionary expenditures, **when [he] knows of his . . . tax liabilities, is capable of meeting them, but does not**," establish willful evasion) (emphasis added). In the typical lavish living case, the debtor's knowledge that he owes a tax is established by:

- the debtor's tax returns showing the tax due, *e.g., Storey*, 640 F.3d at 741;
- the debtor's failure to file returns, *e.g., In re Fegeley*, 118 F.3d at 981;
- the debtor's reliance on a patently meritless tax protester theory, *e.g., Birkenstock*, *supra* (taxpayer refused to pay full tax debt because he treated U.S. paper currency as "pseudo-dollars");
- the debtor's loss of a tax court challenge, *In re Griffith*, 206 F.3d 1389 (11th Cir. 2000); or, most commonly,
- the debtor has been audited, assessed and/or notified by the IRS that he owes taxes, *e.g., Hawkins*,

App. 83-84 (debtor lived lavishly after audit, assessment and notice of deficiency); *In re Gardner*, 360 F.3d at 554-58 (debtor was assessed and liened by IRS, then lived lavishly and concealed assets from IRS's collection efforts).

In cases like Vaughn's, where the debtor files proper returns and is later assessed a tax because the IRS disallows a tax shelter, the debtor's knowledge of and liability for the additional tax does not accrue until the IRS makes the assessment. *See* Internal Revenue Code sections 6303(a) (IRS must issue a notice and demand for payment of tax owed) and 6651(a)(3) (penalties accrue for failure to pay only after taxpayer receives notice and demand for payment). A debtor may know that there is a chance that he will owe a tax in the future, but as long as that probability is not a practical certainty, spending in the face of such a probability is at worst negligent or reckless. It is not willful.

Spies describes "willful" as a "word of many meanings." 317 U.S. at 497. In such situations, this Court often turns to the Model Penal Code for analytic clarity. *E.g., United States v. United States Gypsum Co*., 438 U.S. 422, 440 (1978) ("The ALI Model Penal Code is one source of guidance upon which the Court has relied to illuminate questions of this type."); *United States v. Bailey*, 444 U.S. 394, 403-10 (1980).

The Model Penal Code defines four culpable mental states: purposely, knowingly, recklessly, and negligently. Model Penal Code § 2.02. "Purposely" is equivalent to specific intent. "Knowingly" means the

actor is aware that his conduct is practically certain to cause a particular result. "Recklessly" involves consciously disregarding a substantial and unjustifiable risk of a particular result. "Negligently" means awareness of a substantial and unjustifiable risk of a particular result. *Id.*

In lavish living cases, the "result" of the spending is to put the debtor's money beyond the reach of the IRS. Section 523(a)(1)(C) requires that the debtor do this willfully to lose the right to a discharge. In the Model Penal Code hierarchy of culpability, a willful mental state is satisfied by conduct that is purposeful or knowing, but not reckless or negligent. *Global-Tech Appliances, Inc. v. SEB S.A.,* 131 S.Ct. 2060, 2069-71 (2011) (using Model Penal Code to analyze requirements for willful blindness in patent infringement context); *cf. Kawaauhau*, 523 U.S. at 62 (willfulness under Bankruptcy Code section 523(a)(6) is the mental state required for intentional torts, not for negligent acts). Under this analysis that equates willfulness with at least "knowingly" in the Model Penal Code culpability hierarchy, Vaughn must have known that the IRS was "practically certain" to disallow his KPMG-endorsed tax shelter when he bought his fiancée the house, etc.; and Vaughn must have also known that it was "practically certain" that these spending decisions would result in him having insufficient assets to pay an eventual tax bill, should the IRS disallow the shelter.

Vaughn is an astute businessman, but he is not a tax professional. Son of BOSS transactions are

excruciatingly complex. App. 42-47, 81-82; *Blum v. Commissioner*, 737 F.3d 1303 (10th Cir. 2013). Vaughn's tax shelter was endorsed by a top-tier tax firm, KPMG, as being more likely than not to survive IRS scrutiny. App. 5. That makes Vaughn's reliance presumptively reasonable. *See United States v. Boyle*, 469 U.S. 241, 251 (1985) ("When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice.") (italics in original). Courts have readily found reliance on KPMG's tax advice to be reasonable outside of the bankruptcy discharge context. *See American Boat Co., LLC v. United States*, 583 F.3d 471, 481 (7th Cir. 2009) (taxpayer reasonably relied on his accountants and lawyers who recommended and vouched for Son of BOSS tax planning transaction); *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F.Supp.2d 885, 904-05 (E.D.Tex. 2007) (finding taxpayer's reliance reasonable in identical BLIPS transaction), *aff'd,* 568 F.3d 537 (5th Cir. 2009). At worst, such reliance might be deemed negligent. *See Blum*, 737 F.3d at 1317-18 (upholding negligence penalty for disallowed Son of BOSS transaction).

Only after the IRS disallows a tax shelter and assesses a tax can the debtor's spending, in the face of a now-known tax liability, be considered willful. *In re Rossman*, 487 B.R. 18, 42 (Bkr.D.Mass. 2012) (debtor's participation in accountant-advised tax shelter was not culpable, but discharge denied in part because after assessment debtor failed to pay known

tax obligation in years where he had sufficient excess income); *In re Lynch*, 299 B.R. 62, 68 (Bkr.W.D.N.Y. 2003) (finding no culpability for debtor's participation in accountant-advised tax shelter, but denying discharge because after assessment of taxes debtor chose to live large rather than pay tax debt).

Thus, any court that does not indulge in 20/20 hindsight must conclude that Vaughn's conduct was not willful because it was not at least knowing. In 1999 when Vaughn took the BLIPS deduction, it was not practically certain that this KPMG-endorsed deduction would be disallowed. As well evidenced by the should-have-known-better language that permeates the Bankruptcy Court's opinion, App. 56, 59, 62, 66, Vaughn was at worst negligent because he was aware of a substantial risk that the deduction might be disallowed. *Blum*, *supra*; *American Boat*, *supra*. Liabilities stemming from negligent conduct are eminently dischargeable. *Kawaauhau*, *supra*. The Tenth Circuit courts punished Vaughn because he was wealthy, and hasn't paid his fair share.

b. The debtor must be capable of paying the assessed tax.

The other reason Vaughn's conduct falls short of willfulness is that when he spent his money, he had more money on hand and was working to earn additional amounts that could have gone to pay a possible future tax assessment. Between the spending cited by the IRS (2001-2002) and the IRS's audit and

assessment (2004), Vaughn had the misfortune of being cleaned out by his second divorce settlement (2003). Vaughn could also have reasonably believed that his current business venture would yield additional future income (which unfortunately has not yet come to pass – Vaughn continues to work as a debtor-in-possession to grow the value of his bankruptcy estate). Vaughn was thus able and willing to pay any future tax assessment when he made the spending decisions that the IRS deems culpable. App. 4. The principal reason Vaughn became unable to pay was not because he bought his fiancée a house or funded a trust for his step-daughter, but because he lost nearly all of his wealth in two divorces, before he was assessed.

Courts generally recognize that a debtor's inability to pay a tax debt because of financial catastrophe is not culpable. *See Storey*, 640 F.3d at 45 (rejecting IRS's evasion-through-lavish-spending position because when debtor purchased a home, there was no evidence that debtor "was even aware she would later become unable to pay her taxes"); *In re Fuller*, 189 B.R. 352, 357 (Bkr.W.D.Pa. 1995) (debtor granted discharge over IRS objection where he did not file returns because he honestly believed he had no tax liability; and when he learned that he did have a large tax liability he had no money to pay it); *In re Rhodes*, 356 B.R. 229, 235 (Bkr.M.D.Fla. 2006) (debtor was "blind-sided by the perfect economic storm" created by 2000 tech market crash and 9/11); *In re Segnitz,* 2013 WL 2897048 *6 (Bkr.D.Mass.) (debtor's

"gross income without more does not paint a complete portrait" of his finances; IRS must establish that debtor "actually had the resources to pay the taxes" in order to establish willful nonpayment). *Accord In re Lacheen*, 365 B.R. 475, 486 (Bkr.E.D.Pa. 2007) (if inability to pay tax is not culpable, *e.g.,* not caused by debtor's decision to spend lavishly in the face of the known tax debt, debt should be discharged), citing *In re Angel*, 1994 WL 69516, at *4 (Bkr.W.D.Okla. 1994).

Thus, even if Vaughn is to be punished for his possible negligence of not foreseeing the future tax assessment, his spending was still not culpable. There is nothing wrong with spending a few million on one's family when one has additional millions to cover a possible future IRS tax bill, should it arrive. Vaughn's spending cited by the IRS thus did not "defeat" the IRS's ability to collect a present tax (none had been assessed) or even a future tax.

The Tenth Circuit courts purported to find willfulness only by ignoring Vaughn's undisputed financial chronology, in violation of *Spies*' directive to consider "all the financial circumstances of the taxpayer." 317 U.S. at 498. The Tenth Circuit simply noted instead that willful evasion can be based on pre-assessment conduct. App. 18, citing *Fretz*, *Fegeley* and *Birkenstock*, *supra*. As discussed above, these are all failure-to-file cases, where the debtors' knowledge of their tax debts was established by their failure to

file tax returns.[16] Vaughn filed timely and proper returns, and believed those returns would be accepted by the IRS.

The logical consequence of the Tenth Circuit's holding is that every wealthy taxpayer who takes an apparently legitimate tax deduction, spends commensurately with his wealth, then loses his wealth for any reason (*e.g.,* a business failure or divorce), and is *then* audited and assessed and cannot pay the resulting tax bill, will have committed felony tax evasion. The vagueness in the circuits' definitions of conduct and mental state requirements for willful evasion through lavish living, coupled with the natural antipathy against the once-wealthy who dare to seek a discharge after living lavishly, has resulted in a second category of wrongly-decided willful evasion cases.

3. Specific intent to evade may not be required.

The Ninth Circuit is so far the only circuit court to seriously consider what the plain language of section 523(a)(1)(C) should require for a finding of willful evasion. App. 92 ("Indeed, if simply living beyond one's means, or paying bills to other creditors

[16] These cases are also wrongly decided, to the extent they deny the debtor a discharge for nonpayment or failure to file returns. As discussed, *Fretz* in particular wrongly denies its debtor a discharge for negligently ignoring tax obligations, rather than engaging in any affirmative evasive or defeating conduct.

[besides the IRS] prior to bankruptcy, were sufficient to establish a willful attempt to evade taxes, there would be few personal bankruptcies in which taxes would be dischargeable.") In adopting a specific intent requirement, the Ninth Circuit recognized that it was creating a circuit split in lavish living cases. App. 92, 96; *cf. e.g., Stanley*, 2014 WL 6997518 at *3 ("[T]he debtor need not have [spent] with the specific intent to defraud the IRS."), quoting *United States v. Coney*, 689 F.3d 365, 374 (5th Cir. 2012).

However, even if the Ninth Circuit *en banc* should determine that *Hawkins* overshot the mark by interpreting willfulness as requiring specific intent, this Court still needs to clarify the appropriate standard for willfulness. As discussed above, specific intent is equivalent to the highest Model Penal Code culpability level of purposely. "Willfully defeating" a tax might arguably be accomplished by lavish spending that is at least "knowing," since this Court has equated willfulness with this Model Penal Code culpability level. *Global-Tech Appliances*, *supra*. That is, a debtor need not specifically intend for his spending to defeat the IRS's future collection efforts as long as he knows that such a result is practically certain. *See Reynolds v. I.R.S.*, No. 2014 WL 201610 *3 (D.Mass.) (bankruptcy court denied summary judgment for IRS because debtor's "specific intent" was "notoriously difficult to decide on summary judgment"; reversed on interlocutory appeal because debtor was a tax protestor who knew that her position was frivolous, satisfying mental state requirement of willfulness).

On the other hand, knowingly may not suffice in light of this Court's analysis in *Kawaauhau*, that willfulness under Bankruptcy Court section 523(a)(6) is the mental state required for fully intentional torts. 523 U.S. at 62.

The Ninth Circuit at least seriously considered the language of section 523(a)(1)(C), its relationship to Internal Revenue Code sections 7201 and 7203, and this Court's teachings in *Kawaauhau* and *Spies*. If the culpability level of knowingly is deemed to equate to willfulness in the Bankruptcy Code, per *Global-Tech Appliances*, the Ninth Circuit's specific intent requirement still comports with the language of section 523(a)(1)(C) and this Court's analysis in *Spies* and *Kawaauhau*. *See* Model Penal Code § 2.02(5) (higher culpability level like purposely satisfies lower level like knowingly). The Ninth Circuit thus has the rare status of being the only circuit to interpret section 523(a)(1)(C) correctly, in its analysis of the statute's plain language, parallel Internal Revenue Code provisions, and selection of a culpability level that is at least high enough to satisfy willfulness.

No other circuit has undertaken such an analysis; and as discussed some circuits allow mere negligence to stand in for the willfulness requirement. *E.g., Fretz*, 244 F.3d at 1331 (Eleventh Circuit denying discharge to debtor who merely ignored his tax obligations); *Toti*, 24 F.3d at 809 (same in Sixth Circuit); App. 56, 59, 62, 66. Thus, even if the Ninth Circuit grants *en banc* reconsideration in *Hawkins* and mends the current circuit split by reversing the

panel's specific intent requirement, the circuits are still in disarray in this area of bankruptcy law. Many cases are demonstrably wrong and poorly reasoned, subconsciously substituting Aesop's morality tale for proper, dispassionate legal analysis. The Constitutional requirement for uniformity in the nation's bankruptcy law merits review by this Court.

VI. CONCLUSION

To willfully evade or defeat a tax requires more culpable conduct than not paying one's taxes, not filing returns, or spending one's money on luxuries instead of saving it for a possible future tax bill. In a lavish living case like this, the debtor must have a known tax debt, and know that his spending will result in less money for the IRS. Vaughn did not act willfully here because all of the spending cited by the IRS occurred before Vaughn was assessed a tax, and while he had money to pay a potential future tax bill. That spending was not culpable, and should not have denied him a discharge.

The cases are in disarray. Other circuits besides the Tenth erroneously deny discharges for conduct that is at worst negligent. Courts tend to forgive poor debtors for nonpayment but hold once-wealthy debtors to a higher standard. The Ninth Circuit has split with other circuits by adopting a specific intent requirement.

This Court should grant certiorari to clarify the standard for denying debtors a discharge for willfully

evading or defeating their tax obligations, and remand this case for further proceedings in light of the clarified standard.

January 2015.

Respectfully submitted,

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In re JAMES CHARLES VAUGHN, Debtor.

JAMES CHARLES VAUGHN, Appellant,

v.

UNITED STATES OF AMERICA INTERNAL REVENUE SERVICE, Appellee.

No. 13-1189

United States Court of Appeals, Tenth Circuit

August 26, 2014

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLORADO (D.C. No. 1:12-CV-00060-MSK)

Joseph J. Mellon of The Mellon Law Firm, Denver, Colorado, for Appellant.

Rachel I. Wollitzer, Attorney, Tax Division (John F. Walsh, United States Attorney, of Counsel; Kathryn Keneally, Assistant Attorney General; and Bruce R. Ellisen, Attorney, Tax Division, with her on the brief), Department of Justice, Washington, D.C., for Appellee.

Before TYMKOVICH, McKAY, and MATHESON, Circuit Judges.

McKAY, Circuit Judge.

This appeal arises from an adversary proceeding initiated by Appellant James Charles Vaughn seeking a declaration that his taxes assessed for the years 1999 and 2000 are dischargeable under his Chapter 11 bankruptcy petition. After a trial, the bankruptcy

court determined the taxes were not dischargeable under 11 U.S.C. § 523(a)(1)(C) because Appellant had filed a fraudulent tax return and sought to evade those taxes. The bankruptcy court's decision was affirmed by the federal district court on appeal. Appellant now appeals the district court's order affirming the bankruptcy court's decision.

I.

The following material facts were among those presented to the bankruptcy court at trial. In the mid-nineties, Appellant was Chief Executive Officer of a cable television acquisition company, Frontier-Vision Partners, LP. Though Appellant had little formal education beyond high school, he had significant practical business experience. In the decade-and-a-half prior to becoming CEO of FrontierVision, Appellant served in senior executive positions at a number of cable and communication companies. Appellant was so effective in these positions he was described by one of his colleagues, the Chief Financial Officer at FrontierVision, Jack Koo, as having "as much business acumen as anyone that [Mr. Koo had] known in [his] career." (Supplemental App. at 591.)

Between the years 1995 and 1999, Appellant shepherded FrontierVision as it grew from a start-up venture into a multi-billion dollar company. In 1999, FrontierVision was sold to another company for roughly $2.1 billion. Appellant received approximately

$20 million in cash and $11 million in the purchasing company's stock from this sale.

Appellant testified that around the time of the FrontierVision sale, he realized he "was going to come into a lot of money," and he "needed to do some kind of tax planning, whatever it turned out to be." (Supplemental App. at 532-533.) In June 1999, a partner of the international accounting firm KPMG LLP introduced Appellant to a tax strategy known as Bond Linked Issue Premium Structure ("BLIPS"), which was a product offered by a company called Presidio Advisory Services LLC and marketed by KPMG. FrontierVision had an established relationship with KPMG, which had handled a number of acquisition, tax, and accounting matters for FrontierVision since 1995.

Through a series of communications with representatives of KPMG and Presidio, BLIPS was presented to Appellant in detail. BLIPS was described as a structured, multi-stage program that involved investment in foreign currencies. BLIPS's use as a tax strategy resulted from the manner in which the program combined a participant's relatively small cash contribution to an investment fund (made through a limited liability company), with a nonrecourse loan and a loan premium, ultimately facilitating a high tax loss for the participant without a corresponding economic loss. Through BLIPS, a desired tax loss could be tailored to offset a participant's actual economic gain, and thereby shelter that gain from tax. The BLIPS program was structured so

the basis for a desired tax loss would be achieved by closing out the investment fund after sixty days. In fact, Appellant testified he understood that the ultimate amount he would contribute to his BLIPS investment fund was based on the tax loss he wished to generate to offset his capital gain from the sale of FrontierVision. He also testified that when he entered the BLIPS program in October 1999, he did so knowing he would withdraw by the end of the year – after roughly sixty days – essentially guaranteeing his BLIPS transaction would generate a tax loss covering his capital gains.

KPMG advised Appellant that BLIPS was accompanied by the risks of an IRS audit and the possibility of owing additional taxes. KPMG advised Appellant that in order for a BLIPS transaction to withstand a challenge by the IRS, a participant needed to have a legitimate profit motive in the BLIPS investment. Appellant appreciated the risks associated with BLIPS, stating he understood the BLIPS program "as a choice between paying $9 million of taxes currently or claiming the benefits of [the BLIPS] losses and paying $3 million currently with some risk of paying more taxes later." (Appellant's App. at 1189.) Appellant memorialized his appreciation of these risks when he signed an engagement letter in September 1999 which stated he "acknowledge[d] that [BLIPS] is aggressive in nature and that the [IRS] might challenge the intended results of [BLIPS] and could prevail under any of various tax authorities." (Supplemental App. at 124.)

The letter further stated Appellant "acknowledge[d] that any tax opinion issued by KPMG would not guarantee tax results, but would provide that with respect to the tax consequences described in the opinion, there is a greater than 50 percent likelihood (i.e., it is 'more likely than not') that those consequences will be upheld if challenged by the [IRS]." (*Id.* at 123.) The engagement letter also set forth the $506,000 fee Appellant was to pay KPMG for its role in advising Appellant regarding BLIPS.

The sale of FrontierVision closed on October 1, 1999. Shortly thereafter, between the months of October and December, Appellant participated in a BLIPS transaction. As a result of Appellant's artificially high basis in his BLIPS LLC, his $2.8 million contribution to a BLIPS investment fund, when combined with a loan and loan premium issued to his BLIPS LLC, generated a purported tax loss of roughly $42 million upon Appellant's withdrawal from the BLIPS investment and the disposition of the BLIPS LLC's assets.

On April 11, 2000, Appellant reviewed and signed his 1999 tax return. Appellant reported a long-term capital gain of approximately $30.6 million as a result of the sale of FrontierVision. However, he also reported a short-term capital loss of roughly $32.3 million as a consequence of his BLIPS transaction. He further reported an ordinary loss of roughly $3.3 million based on his BLIPS participation. These claimed losses were sufficient to offset Appellant's capital gains from the sale of FrontierVision. Appellant

admitted at his deposition – and denied at trial – that he had been instructed by one of the partners of KPMG not to claim the full amount of his BLIPS capital loss on his return in order to avoid arousing suspicion. (Supplemental App. at 473-74.) Furthermore, Appellant testified that when he signed the 1999 return, he knew he had not suffered an economic loss corresponding to his claimed tax loss.

In September 2000, the IRS issued Internal Revenue Bulletin Notice 2000-44, in which the IRS discussed "arrangements [that] purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests," including schemes "involv[ing] a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that indebtedness." (Appellant's App. at 1146.) While BLIPS was not specifically mentioned in the notice, the type of transactional scheme described in the notice perfectly described BLIPS. The IRS stated that purported losses resulting from such transactions "are not allowable as deductions for federal income tax purposes" because they "do not represent bona fide losses reflecting actual economic consequences as required for purposes of § 165" of the Internal Revenue Code. (*Id.*) In the wake of this bulletin, KPMG issued a directive requiring BLIPS clients to be notified of Notice 2000-44. Appellant was informed of Notice 2000-44 by KMPG and provided with a copy of the bulletin by February 2001. (*Id.* at 801.)

In March 2001, Appellant separated from his then wife, Cindy Vaughn, and purchased a townhome for $1.4 million. In September, the couple divorced. Pursuant to a separation agreement, Ms. Vaughn received the couple's marital residence – valued at $2.5 million – and five luxury and collector vehicles – valued collectively at roughly $260,000 – while Appellant received the recently purchased townhome and a Mercedes SUV. The couple's Morgan Stanley investment accounts – valued at $18 million – were divided equally. The couple's divorce decree was entered on September 13, 2001.

Shortly after separating from Ms. Vaughn, Appellant entered a relationship with another woman, Kathy St. Onge. In April 2001, Appellant purchased Ms. St. Onge a new BMW. In mid-September 2001, Appellant became engaged to Ms. St. Onge. Around this time, Appellant purchased a $1.73 million home with his own funds, with the home titled in Ms. St. Onge's name only. Appellant married Ms. St. Onge in October 2001.

Meanwhile, in June 2001, Mr. Koo, who had also participated in BLIPS, was notified he was to be audited in relation to his BLIPS participation. In a proof of claim related to a subsequent lawsuit against KPMG, Appellant indicated that Mr. Koo contacted Appellant about the audit shortly after June 2001.[1] In

[1] While the bankruptcy court received conflicting testimony regarding when Appellant was informed of Mr. Koo's audit, the

(Continued on following page)

February 2002, KPMG representatives met with Appellant and informed him that because they were being examined by the IRS in connection with BLIPS, it was likely that Appellant would be identified by the IRS as a BLIPS participant and his 1999 tax return would be subject to audit. Therefore, the representatives suggested that Appellant participate in an IRS voluntary-disclosure program, which permitted taxpayers to avoid certain penalties by voluntarily disclosing their participation in a tax shelter. Following this meeting, KPMG sent Appellant a letter reiterating the recommendation that Appellant voluntarily disclose his participation in BLIPS to the IRS and reemphasizing the likelihood the IRS would acquire information regarding Appellant's participation in the BLIPS program.

In the month following these communications by KPMG, Appellant established an irrevocable trust for his step-daughter, Ms. St. Onge's daughter, on March 4, 2002. Appellant transferred $1.5 million dollars into the trust the day it was established. Ms. St. Onge was named as the trustee and secondary beneficiary. Around three weeks after creating this trust, Appellant submitted a voluntary disclosure of his participation in the BLIPS program to the IRS. Shortly thereafter, in May 2002, the IRS notified Appellant his 1999 tax return was to be examined. Subsequently,

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bankruptcy court ultimately determined Appellant had learned of the audit in 2001.

Appellant was notified his BLIPS investment fund was being investigated.

Throughout this time period, Appellant and Ms. St. Onge spent money in large amounts. For instance, between October 2001 and April 2003, the couple wrote checks to cash, or to themselves, totaling $157,000. Throughout their marriage, which ended in March 2003, the couple spent thousands of dollars in monthly charges to various credit card accounts and spent similarly substantial sums of money on such things as home decoration, jewelry, and cars.

When the couple divorced, Ms. St. Onge received the marital home, two luxury cars, and $3.5 million of the couple's brokerage account. Appellant kept his townhome (by then worth only half of its original purchase price as a result of flood damage), a pick-up truck, a 2002 Chevy Trailblazer, and the remaining balance of the brokerage account, which was smaller than the $3.5 million portion received by Ms. St. Onge. While Ms. St. Onge retained counsel, Appellant did not, nor did he dispute the division of assets.

Immediately prior to his divorce from Ms. St. Onge, the IRS notified Appellant that his ex-wife, Cindy Vaughn, had filed a request for innocent-spouse relief with respect to their 1999 tax return. In August of 2003, Appellant filed his own request with the IRS for such relief, stating in a supporting affidavit that "[b]ecause of the inequitable transfers of assets to Cindy pursuant to divorce, I do not have the assets to pay all the deficiencies attributable to

[BLIPS]." (Appellant's App. at 1198.) He further stated in the affidavit that he "would be bankrupt if the IRS assesses and collects the full . . . liability" attributed to his BLIPS participation. (*Id.*) He also stated that while he "received about $10.4 million of assets in the divorce [from Ms. Vaughn] . . . since then [his] net worth has dropped to about $4 million." (*Id.*) While Appellant's request for innocent-spouse relief mentioned he had been remarried and divorced since his divorce from Ms. Vaughn, he did not mention the trust set up for his step-daughter, nor did he mention the unequal division of assets during his divorce from Ms. St. Onge.

In March 2004, Appellant filed an amended 1999 tax return from which he did not remove his BLIPS-generated losses. In May 2004, the IRS issued an announcement regarding a settlement initiative for participants in BLIPS-type tax shelters. While Appellant sought to participate in this settlement program, he was ineligible because he was unable to make full payment of his tax liabilities related to his participation in BLIPS.

In June 2004, the IRS notified Appellant of an approximately $8.6 million tax deficiency arising from the IRS's determination that Appellant had overstated his losses as a result of his BLIPS participation. In a subsequent notice, the IRS notified Appellant of an additional tax deficiency of roughly $120,000 for the year 2000 relating to the carry-forward of a disallowed investment-interest expense arising out of Appellant's BLIPS participation.

II.

In November 2006, Appellant filed his Chapter 11 bankruptcy petition. The IRS subsequently filed a proof of claim in that action for tax assessments for the years 1999 and 2000 in the amount of $14,359,592.[2] Appellant initiated an adversary proceeding seeking a declaration that the taxes were dischargeable. The matter proceeded to trial, whereupon the bankruptcy court found that Appellant had both filed a fraudulent tax return and willfully evaded his taxes, which provided two independent grounds for finding his tax liability nondischargeable under 11 U.S.C. § 523(a)(1)(C). Under this section, statutory discharges do "not discharge an individual debtor from any debt [ ] for a tax or customs duty . . . with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C).

Appellant appealed the bankruptcy court's decision to the federal district court, which affirmed the bankruptcy court's order. However, finding "no error with regard to the Bankruptcy Court's determination that [Appellant] willfully attempted to evade his 1999

[2] We note the IRS initially filed its "proof of claim for $14,359,592 as an unsecured claim, stating at that time the taxes were not entitled to priority under 11 U.S.C. § 507(a)(8)(A)." *Vaughn v. IRS (In re Vaughn),* 463 B.R. 531, 539 (Bankr. D. Colo. 2011). However, realizing this to be an error, the "IRS abated the 2004 Assessment as unlawful, and on April 10, 2008, . . . filed its amended proof of claim, asserting the taxes were entitled to priority." *Id.* at 540.

and 2000 tax obligations," thereby rendering his tax obligations non-dischargeable, the district court declined to address the question of whether Appellant filed a fraudulent tax return. *Vaughn v. IRS,* No. 12-CV-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2013) (unpublished) at *2.[3] In the course of its opinion, the district court stated that the bankruptcy court "engaged in a comprehensive and holistic review . . . of the evidence," *id.* at *5, when faced with the difficulty of "attempt[ing] to follow the elemental approach" to willful evasion under § 523(a)(1)(C), which generally requires that "two, discrete elements . . . be proved in order to reach a 'willful evasion' determination: (i) a conduct requirement; and (ii) a mental state requirement," *id.* at *5 n.8.

III.

Appellant now raises two primary issues on appeal. First, Appellant argues the district court impermissibly employed "a 'holistic' review of the evidence to support its affirmance of the Bankruptcy Court's willful evasion determination" in order to avoid determining whether the evidence before the

[3] Despite numerous allusions to the bankruptcy court's fraudulent return finding in Appellant's briefing to this court on appeal, Appellant urges that "[b]ecause the District Court did not rule on [it], the fraudulent return finding by the Bankruptcy Court was not argued in Appellant's opening brief." (Appellant's Reply Br. at 1.) Therefore, we limit our review to the issue of whether Appellant willfully attempted to evade his tax obligations.

bankruptcy court satisfied "the two discrete elements of willful evasion." (Appellant's Opening Br. at 2.) Second, Appellant argues the bankruptcy court's finding that Appellant willfully attempted to evade his tax obligations was erroneously based on negligent, rather than willful, conduct.

"Our review of the bankruptcy court's decision is governed by the same standards of review that govern the district court's review of the bankruptcy court. Accordingly we review the bankruptcy court's legal determinations *de novo* and its factual findings under the clearly erroneous standard." *Conoco v. Styler (In re Peterson Distrib., Inc.),* 82 F.3d 956, 959 (10th Cir. 1996) (citations omitted).

Regarding the first issue, Appellant argues that the district court impermissibly construed our opinion in *Dalton v. IRS,* 77 F.3d 1297 (10th Cir. 1996) to allow a "holistic" review of the evidence before the bankruptcy court. While the district court included a lengthy footnote in its opinion discussing the expediency of such a "holistic" review in light of *Dalton, see Vaughn v. IRS,* 2013 WL 1324377, at *5 n.8, no such "holistic" review was mentioned or applied by the bankruptcy court. Because "[o]ur review [is] of the bankruptcy court's decision," *Conoco,* 82 F.3d at 959, we need not consider the district court's application of holistic review. The bankruptcy court explicitly noted that "[t]he most recent appellate decision addressing § 523(a)(1)(C) identified two components to a showing of willful evasion: 1) a conduct requirement; and 2) a mental state requirement." *Vaughn v. IRS (In re*

Vaughn), 463 B.R. 531, 545 (Bankr. D. Colo. 2011) (citing *United States v. Storey,* 640 F.3d 739, 744 (6th Cir. 2011)). The bankruptcy court applied this two-element approach, citing factual findings in support of the conduct and mental state requirements separately, with each requirement commanding its own subsection of the bankruptcy court's opinion. Since the bankruptcy court, which is the subject of our ultimate review, applied the two-element approach in determining that Appellant willfully attempted to evade a tax, we need not determine whether the district court's application of a "holistic" review of the evidence before the bankruptcy court is permissible under our decision in *Dalton.*

Turning to whether the bankruptcy court properly found the Appellant willfully, rather than negligently, attempted to evade or defeat his tax liability, we note that "[w]hether or not a debtor willfully attempted to evade or defeat a tax [under 11 U.S.C. § 523(a)(1)(C)] is a question of fact reviewable for clear error."[4] *United States v. Jacobs (In re Jacobs),* 490 F.3d 913, 921 (11th Cir. 2007) (citing *Dalton,* 77 F.3d at 1302). "A finding of fact is clearly erroneous if it is without factual support in the record or if, after

[4] Appellant argues we ought to review the bankruptcy court's willful evasion determination de novo, claiming the bankruptcy court erred as a matter of law by applying a negligence standard to find that Appellant evaded his tax obligation. For the reasons discussed below, we are not persuaded the bankruptcy court based its finding of willful evasion on negligent, rather than willful, conduct.

reviewing all of the evidence, we are left with the definite and firm conviction that a mistake has been made." *Conoco,* 82 F.3d at 959. Where, as here, certain "findings are based on determinations regarding the credibility of witnesses, Rule 52(a) [of the Federal Rules of Civil Procedure] demands even greater deference to the trial court's findings."

Anderson v. Bessemer City, 470 U.S. 564, 575 (1985).

The bankruptcy court explicitly found that "[Appellant's] actions meet the state of mind test to show intent to evade tax" under § 523(a)(1)(C). *In re Vaughn,* 463 B.R. at 548. In making this finding, the bankruptcy court quoted this court's holding that a "debtor's actions are willful under § 523(a)(1)(C) if they are done voluntarily, consciously or knowingly, and intentionally." *Dalton,* 77 F.3d at 1302. The bankruptcy court also noted that § 523(a)(1)(C)'s mental state requirement is generally satisfied "where the government shows the following three elements: 1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty." *In re Vaughn,* 463 B.R. at 546 (citing *Jacobs,* 490 F.3d at 921 and *Hawkins v. Franchise Tax Bd.,* 447 B.R. 291, 300 (N.D. Cal. 2011)). Applying these principles, the bankruptcy court found Appellant knew he "had a duty under the law" which he "voluntarily and intentionally violated," thus satisfying § 523(a)(1)(C)'s mental state requirement. *Id.* The bankruptcy court cited several facts in support of this finding, including the following: the fact Appellant "exhibited behavior

which was inconsistent with his business acumen" by "participat[ing] in the BLIPS investment" and subsequently depleting his assets, "knowing as he must have, the BLIPS investment constituted an improper abusive tax shelter with no economic basis and no reasonable expectation of profit"; Appellant's knowledge of Mr. Koo's BLIPS-related audit in 2001; Appellant's receipt of the IRS's Notice 2000-44 in early 2001; Appellant's receipt of notification from KPMG in early 2002 regarding the IRS's investigation into BLIPS and KPMG's opinion that the investigation would likely lead to Appellant being audited for his BLIPS participation; and Appellant's "purchas[e of] expensive homes, automobiles, and jewelry, following a divorce which significantly depleted his assets," "as if there would be no additional tax to pay," despite the aforementioned facts. *In re Vaughn,* 463 B.R. at 547. The bankruptcy court likewise found Appellant's actions, taken in light of Appellant's knowledge of his impending tax liability, satisfied the conduct requirement of § 523(a)(1)(C).[5]

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[5] The bankruptcy court cited a number of facts supporting its finding that Appellant's actions satisfied § 523(a)(1)(C)'s conduct requirement. For instance, the bankruptcy court found that even though "he had transferred approximately one-half of his post-Frontier[ ] Vision sale assets to Cindy Vaughn as part of their divorce settlement, he failed to take any actions to preserve his remaining assets for the payment of additional taxes," notwithstanding the fact that he "knew he had a potential [tax] liability on the full amount of his gain from the Frontier[ ] Vision sale." *In re Vaughn,* 463 B.R. at 546. Instead he made numerous large expenditures, including the "purchase[ ] of a $1.7 million

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Appellant offers four primary arguments in support of his assertion that the bankruptcy court's willful evasion finding was based on negligent conduct rather than the willful conduct required by the text of § 523(a)(1)(C). First, Appellant argues that a finding of "willful evasion requires knowledge that a tax is owed – not just knowledge of a possibility that the IRS might assess tax liability sometime in the future." (Appellant's Opening Br. at 32.) Appellant argues that because the spending and asset disposition cited by the bankruptcy court in support of its willful evasion finding "took place long before the IRS assessed a tax penalty," the willful evasion finding is, at best, "premised on [Appellant's] disposition of his assets when he arguably *should have known* that the IRS might assess a tax in the future, if it rejected [Appellant's] BLIPS transaction." (*Id.* at 25 (emphasis in original).) Appellant argues that such a "determination of evasion based upon a potential tax liability is really just a . . . negligence finding." (*Id.* at 27 (internal quotation marks and brackets omitted).)

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home . . . [the title of which was] in the sole name of . . . Kathy St. Onge," the creation and funding of "a $1.5 million trust for his step-daughter" shortly before disclosing his participation in BLIPS to the IRS, and several purchases of jewelry and other luxury items. *Id.; see Hawkins,* 447 B.R. at 301 ("[L]arge discretionary expenditures, combined with nonpayment of a known tax, contribute[ ] to the conduct analysis. Moreover nonpayment of a tax can satisfy the conduct requirement when paired with even a single additional culpable act or omission."); *see also Jacobs,* 490 F.3d at 926-27 (stating that large discretionary expenditures are relevant to the § 523(a)(1)(C) conduct element).

Contrary to Appellant's assertions, we have previously held that the assessment of a tax is not required in order for a debtor's conduct to be considered willful. In *Dalton,* we held that the actions of a debtor – including the purchase of a condominium and the transfer of funds to his fiancee – taken when he "knew of [a] tax investigation which was likely to result in a significant assessment," but prior to an actual tax assessment, were willful for purposes of § 523(a)(1)(C). 77 F.3d at 1303. Additionally, a number of courts have unequivocally stated that the failure to file a tax return, which necessarily occurs before a tax is assessed or concretely known, is considered a willful omission under § 523(a)(1)(C). *See, e.g., United States v. Fretz (In re Fretz),* 244 F.3d 1323, 1329 (11 Cir. 2001); *United States v. Fegeley (In re Fegeley)*, 118 F.3d 979, 983-84 (3d Cir. 1997); *In re Birkenstock,* 87 F.3d 947, 951 (7th Cir. 1996). These authorities establish that actions taken with knowledge of an anticipated tax obligation can be considered willful, rather than negligent, thus rendering tax debts non-dischargeable in bankruptcy. To the extent Appellant ultimately disputes that he did not know of the anticipated tax obligation, the bankruptcy court found to the contrary and that conclusion was not clearly erroneous.

Second, Appellant argues his "reliance on the advice of KPMG, his longtime tax advisor, that the BLIPS transaction was an aggressive but ultimately legitimate tax position might have been at worst unreasonable under the circumstances, making

[Appellant] negligent," but not willful. (Appellant's Opening Br. at 23.) Appellant contends that because he innocently, even if unreasonably, relied on KPMG's advice, he cannot be found to have acted willfully. We find this argument unpersuasive under all of the circumstances in this case, particularly in light of the bankruptcy court's finding that Appellant's assertion of innocent reliance was "simply not credible." *In re Vaughn,* 463 B.R. at 548.

Third, Appellant suggests our recent opinion in *Blum v. Commissioner,* 737 F.3d 1303 (10th Cir. 2013), must control our review of this case. The facts in *Blum* are similar to those in Appellant's case. The plaintiff in *Blum* was a self-made business man who participated in a different tax shelter marketed by KPMG. The IRS sent the *Blum* plaintiff a notice disallowing the losses he claimed in connection with the tax shelter and imposing "two accuracy-related penalties for underpayment of taxes," *id.* at 1306, including a penalty for "negligent underpayment" under I.R.C. § 6662(b). The tax court upheld this decision. On appeal, we affirmed the imposition of the negligent underpayment penalty, despite the *Blum* plaintiff's assertion that he merely relied on KPMG's representations regarding the validity of the tax shelter. In the case before us, Appellant argues our decision affirming a negligent underpayment penalty in *Blum* "confirms[that Appellant's] decision to rely on KPMG's tax advice is not blameless, but . . . does not rise to the level of intentional or knowing conduct either." (Appellant's Reply Br. at 17.) Appellant's

suggestion that *Blum* controls our decision in this case is unpersuasive. Our decision to uphold a negligent underpayment penalty in *Blum* does not prove that Appellant's conduct in this case failed to rise above the level of negligence. The fact that the conduct in *Blum* was sufficient to support a finding of negligence does not require us to find the bankruptcy court's finding of willful evasion in this case to be clearly erroneous.

Finally, Appellant argues the bankruptcy court's order "couched all of its criticism of [Appellant's] conduct with terms generally used to describe negligent conduct." (Appellant's Reply Br. at 9.) Appellant particularly mentions the bankruptcy court's use of the terms "reasonably" and "known or should have known" as terms that he claims generally convey negligence rather than willfulness. While the bankruptcy court did use those terms in its opinion, it did not do so in a way suggesting Appellant's actions were merely negligent. Rather, in the context of the bankruptcy court's opinion as a whole, such language was simply used to express the bankruptcy court's conclusions that Appellant "must have been aware," *In re Vaughn,* 463 B.R. at 544, of the circumstances demonstrating the invalidity of his BLIPS losses, and that Appellant chose to claim those losses on his tax returns and to deplete his remaining assets, "knowing, as he must have, the BLIPS investment constituted an improper abusive tax shelter," *id.* at 547. Therefore, the language identified by Appellant as suggesting a negligence-based finding, when read in

context, actually buttresses the bankruptcy court's finding that Appellant willfully attempted to evade his tax obligations.

IV.

Ultimately, none of Appellant's arguments persuade us the bankruptcy court's determination that Appellant willfully attempted to evade his tax obligations is clearly erroneous. Appellant fails to demonstrate why we should not defer to the bankruptcy court's factual finding that Appellant willfully attempted to evade his tax liability under § 523(a)(1)(C). For the foregoing reasons, we AFFIRM the district court's decision to affirm the order of the bankruptcy court.

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

In re: JAMES CHARLES VAUGHN,

Debtor.

JAMES CHARLES VAUGHN,

Appellant,

v. (D.C. No. 1:12-CV-00060-MSK)

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellee.

ORDER

(Filed Nov. 10, 2014)

Before **TYMKOVICH, McKAY,** and **MATHESON,** Circuit Judges.

Appellants' motion to stay the mandate pending the filing of a petition for a writ of certiorari in the Supreme Court is granted.

Issuance of the mandate is stayed until February 9, 2015. If a notice from the Supreme Court clerk is filed with this court during the stay period indicating that appellants have filed a petition for certiorari,

the stay continues until the Supreme Court's final disposition.

Entered for the Court

/s/ Elisabeth A. Shumaker

ELISABETH A. SHUMAKER,
Clerk

United States District Court, D. Colorado.

JAMES CHARLES VAUGHN,
Appellant and Cross-Appellee,

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,
Appellee and Cross-Appellant.

Civil Action No. 12-cv-00060-MSK

March 29, 2013

OPINION AND ORDER AFFIRMING BANKRUPTCY COURT DECISION

MARCIA S. KRIEGER, District Judge.

THIS MATTER is before the Court for review of the December 28, 2011 Order and Judgment of the United States Bankruptcy Court determining that a tax debt owed by Debtor James Vaughn to the Internal Revenue Service ("the IRS") was not dischargeable under 11 U.S.C. § 523(a)(1)(C).

I. Procedural Background and Jurisdiction

Mr. Vaughn filed a voluntary Chapter 11 Petition in November 2006. The IRS filed a proof of claim in that action in the amount of $14,359,592.[1] In 2008,

[1] The claim was originally denominated as an unsecured claim because the taxes were not entitled to priority under 11 U.S.C. § 507(a)(8)(A). The IRS later amended the claim, asserting that

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Mr. Vaughn initiated an adversary proceeding seeking a declaration that the taxes were dischargeable. The IRS answered and asserted that the taxes were non-dischargeable under 11 U.S.C. § 523(a)(1)(A) and 11 U.S.C. § 523(a)(1)(C).[2] The IRS filed a motion for partial summary judgment requesting a determination that Mr. Vaughn's tax liability was non-dischargeable under 11 U.S.C. §§ 523(a)(1)(A) and § 507(a)(8)(A)(iii). That motion was denied, and the matter proceeded to trial on issue of dischargeability of the tax liability under 11 U.S.C. § 523(a)(1)(C). The Bankruptcy Court determined that Mr. Vaughn's tax liability was non-dischargeable under § 523(a)(1)(C) both because Mr. Vaughn had filed a fraudulent tax return and had willfully evaded his taxes. The parties have cross-appealed.[3] This Court exercises jurisdiction pursuant to 28 U.S.C. § 158(a)(1).

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the taxes were entitled to priority. Their status is not relevant to whether they are excepted from discharge.

[2] Although asserted as defenses by the IRS, the Bankruptcy Court characterized them as counterclaims, as does this Court.

[3] Mr. Vaughn challenges the Bankruptcy Court's determinations that he made a fraudulent return and willfully attempted to evade or defeat his taxes (11 U.S.C. § 523(a)(1)(C)). The IRS challenges the Bankruptcy Court's denial of its motion for summary judgment requesting a determination that Mr. Vaughn's 1999 and 2000 federal income tax liabilities were excepted from discharge under 11 U.S.C. § 507(a)(8)(A)(iii).

II. Material Facts found by the Bankruptcy Court

Mr. Vaughn operated a successful cable company that was sold in 1999 for $2.1 billion. For his interest in the company, Mr. Vaughn received $20 million in cash and $11 million in Adelphia Communications Corporation stock.

Knowing that he would have to recognize taxable capital gains from the sale, Mr. Vaughn consulted with the accounting firm that served his company, KMPG. The company's former chief financial officer, Mr. Jack Koo, who also profited from the sale, also sought tax advice from KPMG.

To offset gain realized from the sale, KPMG presented Mr. Vaughn and Mr. Koo with an investment product called a "Bond Linked Issue Premium Structure" (BLIPS). Reduced to simplest essence, the BLIPS used a combination of a small cash investment, a loan, and a loan premium to facilitate a high tax loss without a corresponding economic loss. The high tax loss was intended to offset the gain that Mr. Vaughn and Mr. Koo incurred as a result of the business sale. Both gentlemen invested in the BLIPS product.

Mr. Vaughn and his then-wife filed their 1999 and 2000 tax returns, offsetting the gains from the sale of the company with the losses generated by the BLIPS investment. Consequently, they reported only $2.4 million in capital gains from the sale.

In September 2000, the IRS issued Internal Revenue Bulletin Notice 2000-44, which addressed tax avoidance using artificial basis tax shelters similar to the BLIPS, advised that resulting losses could not be used as deductions for federal income tax purposes, and stated that appropriate penalties could be imposed on participants in such transactions. KPMG sent Mr. Vaughn a copy of this Notice on February 6, 2001. In June of 2001, Mr. Vaughn learned that Mr. Koo was being audited by the IRS with regard to his 1999 return, and that the BLIPS investment was a focus of the audit.

In February 2002, counsel for KPMG met with Mr. Koo and Mr. Vaughn to discuss an IRS settlement initiative for investors in structures like the BLIPS. The attorney advised Mr. Vaughn that he should disclose his participation in the BLIPS to the IRS. He did so in late March 2002. He also provided other information requested by the IRS, and agreed to extension of the statute of limitation to allow the IRS to continue its investigation concerning losses reported on this 1999 tax return. In May 2002 Mr. Vaughn received a letter from the IRS scheduling an appointment to examine his 1999 tax returns.

During 2000 and 2001, after the Internal Revenue Bulletin notice had been send to him, Mr. Vaughn substantially reduced his assets. In September 2001, his divorce from Cindy Vaughn was finalized, leaving him with approximately $9 million in assets. The following month, he purchased a $1.7 million house and titled it in his fiancé's name. Mr. Vaughn's fiancé

spent another $100,000 on décor at the home and $42,000 on jewelry. In March 2002, after meeting with KMPG's counsel, Mr. Vaughn funded a $1.5 million trust for his step-daughter and spent approximately $20,000 on jewelry. These transfers ensured that there would be inadequate funds to satisfy his tax obligations.

III. Analysis

A. Standard of Review

This Court reviews conclusions of law *de novo*. *Connolly v. Harris Trust Co. of Ca.* (*In re Miniscribe Corp.*), 309 F.3d 1234, 1240 (10th Cir. 2002) (citation omitted). Factual findings are reviewed for clear error. *Id.* Factual findings are entitled to deference, unless they are without factual support in the record, or if this Court, having reviewed the evidence, is left with a firm conviction that a mistake has been made. *In re Ford,* 492 F.3d 1148, 1153 (10th Cir. 2007).

B. Dischargeability of Mr. Vaughn's tax obligation

One goal of a debtor in bankruptcy is to discharge pre-petition debts. The types of debts that are excepted from discharge are listed Section 523 of Title 11. The cross-appeals focus on two exceptions – 11 U.S.C. § 523(a)(1)(C) and 11 U.S.C. § 523(a)(1)(A).

Mr. Vaughn asserts error in the Bankruptcy Court's determinations under 11 U.S.C. § 523(a)(1)(C)

that he: (i) made a fraudulent tax return and (ii) willfully attempted to evade or defeat taxes owed for years 1999 and 2000.[4] The IRS asserts error in the Bankruptcy Court's denial of its Motion for Summary Judgment in which it sought a determination that the taxes owed for 1999 and 2000 were non-dischargeable pursuant to 11 U.S.C. § 523(a)(1)(A). The Court begins with Mr. Vaughn's challenges.

Under 11 U.S.C. § 523(a)(1)(C), tax debts can be excluded from discharge on two alternative grounds: (i) making a fraudulent return or, (ii) willfully attempting to evade or defeat a tax. The Bankruptcy Court determined that Mr. Vaughn's tax debt was excepted from discharge on both grounds. Mr. Vaughn challenges both determinations, but in order for this Court to reverse the finding of non-dischargeableability of the tax debt, Mr. Vaughn must show that *both* determinations are erroneous. Because the Court finds no error with regard to the Bankruptcy Court's determination that Mr. Vaughn willfully attempted to evade his 1999 and 2000 tax obligations, it is unnecessary

[4] In his briefing, Mr. Vaughn focuses on two asserted errors: (i) the Bankruptcy Court erred in determining Mr. Vaughn's reliance on tax professionals such as KPMG was unreasonable; and (ii) the Bankruptcy Court erred in finding that Mr. Vaughn willfully evaded his tax obligations based on his spending before he knew or had reason to know of his potential tax liability. These contentions involve factual findings by the Bankruptcy Court and are addressed in the Court's analysis.

to address the interesting issues[5] raised by Mr. Vaughn with regard to the Bankruptcy Court's finding that he filed a fraudulent tax return. For the same reason it is not necessary to explore the issues raised by the IRS in its cross-appeal.

Turning to the question of whether Mr. Vaughn willfully attempted to evade his tax obligations, Mr. Vaughn identifies two alleged errors by the Bankruptcy Court: one of law and one of fact. To understand these arguments, it is important to recognize the context of the Bankruptcy Court's finding.

The statutory language of § 523(a)(1)(C) is broad, extending to any willful attempted to evade or defeat a tax. Here, the Bankruptcy Court was concerned with allegations that Mr. Vaughn concealed or transferred assets in order to prevent them from being used to pay his 1999 and 2000 tax liability. The Bankruptcy Court relied on 10th Circuit authority,[6]

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[5] Among other things, Mr. Vaughn contends that IRS Notice 2000-44 and Reg. Section 1.752-6 should not have be applied retroactively to his 1999 and 2000 tax returns; that the Bankruptcy Court improperly discounted Mr. Vaughn's reliance on his tax professionals at KPMG; and that the Bankruptcy Court's findings only supported a finding that he acted negligently, but non-dischargeability for making a fraudulent return requires a showing of intent.

[6] *Dalton v. Internal Revenue Service*, 77 F3d 1297 (10th Cir. 1996).

as well as authority from outside of this Circuit,[7] that found a "willful attempt to evade or defeat a tax" when a debtor made large discretionary expenditures or concealed or transferred assets so as to render them unreachable by the IRS. In addition, the Bankruptcy Court made extensive factual findings relative to Mr. Vaughn's business sophistication, the time that he became aware of his potential tax liability, and the disposal or consumption of his assets. The Court stated:

> Vaughn exhibited behavior which was inconsistent with his business acumen and was implausible based on that acumen when he participated in the BLIPS investment, Further, by purchasing expensive homes, automobiles, and jewelry, following a divorce which significantly depleted his asses, he further demonstrated such inconsistent behavior. That is, knowing, as he must have, the BLIPS investment constituted an improper abusive tax shelter with no economic basis and no reasonable expectation of profit, he nonetheless continued to spend as if there would be no additional tax to pay. This is simply not logical, unless he had another motive for such spending.
>
> The evidence before the Court not only demonstrates he spent the funds and made the

[7] *United States v. Torey,* 640 F3d 739,744 (6th Cir. 20122); *United States v. Jacobs,* 490 F3d 913, 921 (11th Cir 2007); *United States v. Fegeley,* 118 F3d 979,983 (3rd Cir 2000).

> transfers in face of serious financial difficulties, but also indicates his motive in doing so was to reduce assets subject to potential IRS execution. In short, by transferring funds and assets to [his fiancé] and [his stepdaughter] he attempted to take those funds and assets out of the reach of the IRS.

As a legal matter, Mr. Vaughn argues that a debtor must know of a fixed or actual tax liability at the time of transferring assets in order to willfully evade a tax. He further contends that because there had been no assessment or quantification of his 1999 and 2000 tax liability at the time that he made the subject transfers, he could not have willfully attempted to evade such taxes. In support of his legal premise – that a debtor must know of an actual or fixed tax liability – Mr. Vaughn offers a survey of opinions in which willful evasion under § 523 was found or affirmed on appeal. He categorizes the opinions in three groups: (i) cases where the debtor's knowledge of tax liability is established by his failure to file a return; (ii) cases where the debtor's knowledge of tax liability is established by the debtor's failure to pay a known tax liability when it is due; and (iii) cases where the debtor learns of a tax liability based on a government decision rejecting the debtor's tax planning strategy. Mr. Vaughn acknowledges in his briefing that "in most of these willful evasion cases, the debtor's knowledge of his tax liability is apparent, and is therefore not discussed or considered extensively. The focus is on the debtor's expenditures and lavish living." (#20 p. 32) But then

Mr. Vaughn draws the unsupported conclusion that the cases "uniformly confirm that liability for willful evasion cannot be based on spending that occurs before the debtor knows that he owes taxes." (#20 p. 32)

Having carefully reviewed the opinions cited by Mr. Vaughn, the Court finds none that address the question of whether there must be a fixed and actual tax liability of which the debtor is aware in order to find willful evasion. Put another way, none of these cases consider whether a debtor's knowledge of an IRS investigation or of a potential tax liability is a sufficient predicate for consideration of the debtor's conduct. At oral argument, the Court inquired of counsel as to whether there was any authority that required the debtor to know of an actual or fixed tax liability in order to find willful evasion based upon concealment or transfer of assets. Neither counsel could identify such authority.

There is authority to contrary, however. The Tenth Circuit opinion in *Dalton v. I.R.S.,* 77 F.3d 1297 (10th Cir. 1996), is most instructive. In *Dalton,* the Tenth Circuit affirmed a Bankruptcy Court's determination that a Chapter 7 debtor's tax obligations were non-dischargeable pursuant to 11 U.S.C § 523(a)(1)(C) due to willful evasion. The Bankruptcy Court found that the debtor had attempted to conceal his ownership interest in his condo. The debtor argued that he could not have been evading taxes, because he was solvent and had no tax assessments at the time he purchased the condo (the tax assessments were made two years later). In essence, he made the same

argument that is raised here – at the time of the concealment, he did not know of an actual or fixed tax liability.

In affirming the bankruptcy court's determination, the Circuit Court began with the observation that the language of 11 U.S.C § 523(a)(1)(C), "willfully attempted in any manner to evade or defeat," is unambiguous, having been widely interpreted in tax cases. *Id* at 1301. Then it noted that although the failure to pay taxes, alone, does not compel a finding that a given tax debt is nondischargeable, nonpayment is relevant evidence which a court should consider in the "totality of the conduct" of the debtor. Consistent with that view, it then turned to the factual findings made by the bankruptcy court.

> A debtor's actions are willful under 11 U.S.C § 523(a)(1)(C) if they are done voluntarily, consciously or knowingly and intentionally. (citation deleted) The determination that a debtor willfully concealed assets is a finding of fact which we review for clear error.

Id. at 1302.

The Court pointed to two factual findings pertinent to the debtor's knowledge. First, the Bankruptcy Court accepted the testimony of an IRS agent who informed the debtor of a personal tax investigation on or before the debtor's acquisition of the condo. Second, the Bankruptcy Court quoted from a settlement document that provided for a quitclaim of the condo to the debtor "subject to all claims of the United

States or any tax liability now validly assessed or hereafter validly assessed." When the debtor received the deed to the condo, he quitclaimed his interest to his wife before recording his interest.

These factual findings were sufficient for the Circuit Court to affirm the Bankruptcy Court's determination of nondischargeability. In doing so, the Circuit Court stated:

> in making its ultimate finding of willful concealment in order to evade or defeat taxes, the court first found that at the time of the purchase, Dalton knew of the tax investigation which was likely to result in a significant assessment, his transfers of money to his betrothed's account were accomplished without any documentation which would properly account for the transaction, and that these circumstances, combined with his actions respecting the settlement . . . indicated an intent to conceal his interest in the condo to avoid attachment of the IRS liens. This finding is not clearly erroneous.

Id. at 1303.

Dalton is important both for its factual similarity to this case and for the analytical approach taken by Court. There was no fixed or actual tax debt at the time Mr. Dalton concealed his ownership in the condo; he knew only of an IRS investigation and possible tax liability. This knowledge was nevertheless

sufficient to support the finding of "willful evasion."[8] In light of this precedent and the apparent absence of any caselaw standing for the proposition that

[8] The other interesting feature of *Dalton* is its deference to the factual findings made by the bankruptcy court. Rather than parsing evidence relevant to Mr. Dalton's intent separately from that relevant to his conduct, the Court appears to endorse a holistic review of all of the evidence.

This reflects a different approach than that taken in more recent decisions in other circuits. For example, some courts recognize two, discrete elements that must be proved in order to reach a "willful evasion" determination: (i) a conduct requirement; and (ii) a mental state requirement. *See United States v. Storey,* 640 F3d 739,744(6th Cir 2011); *United States v. Jacobs,* 490 F.3d 913, 921 (11th Cir. 2007); *United States v. Fegeley,* 118 F3d 979, 983(3rd Cir. 2000). Although this methodology does not result in an outcome different from *Dalton,* it leads to an artificial compartmentalization and distinction between conduct and state of mind which leads trial courts to attempt to define and then make findings pertinent to each.

In actuality, although conduct and state of mind are both components of the § 523(a)(1)(C) analysis, they are not neatly separated. The debtor's state of mind arguably must be considered at two junctures. First, was the debtor's conduct done willfully, that is voluntarily, consciously, knowingly, and intentionally as compared to being the result of ignorance, coercion or a mistake? Second, what was the debtor's purpose or intent in engaging in such conduct-was it to defeat or evade a tax or for some other purpose such as altruism or generosity? As noted by many courts, intent is rarely expressed. Instead, it is inferred from the debtor's conduct. Thus, the analysis becomes quite circular. The Tenth Circuit's holistic, fact driven approach avoids such analytical circularity.

It is clear that the Bankruptcy Court attempted to follow the elemental approach and had difficulty doing so. Ultimately, it wove its findings together in the holistic manner anticipated by *Dalton.*

knowledge of an actual or fixed liability is required for a finding of "willful evasion," this Court finds no legal error in the Bankruptcy Court's determination.

Mr. Vaughn's second argument is that there was insufficient evidence in the record to support the Bankruptcy Court's finding that Mr. Vaughn knew of a tax liability for 1999 and 2000 at the time he dissipated his assets. Instead, Mr. Vaughn contends that he did not know of his tax liability until 2003 or 2004. This is a purely factual issue, to which the Court defers to the credibility determinations made by the trial court.

The Court appreciates that this argument derives from Mr. Vaughn's legal position that for "willful evasion" to occur, the debtor must know of a fixed or actual tax debt, and that he did not know, with certainty, the amount of his tax obligation until 2003 or 2004. In accordance with *Dalton,* the Bankruptcy Court engaged in a comprehensive and holistic review of the review of the evidence. Although Mr. Vaughn's liability may not have been quantified until 2003 or 2004, the Bankruptcy Court found that when Mr. Vaughn invested in the BLIPS, he knew there was some risk that the losses he would claim to offset his gains might not be recognized by the IRS. In 2001, when he purchased a home that he titled in the name of his fiancé, he also had been informed of the IRS's position in the Notice 2000-44 and knew that Mr. Koo was subject to an IRS audit regarding the BLIPS transaction. Later, after being advised by KPMG counsel to disclose his BLIPS investment to the IRS

but before doing so, Mr. Vaughn transferred $1.5 million to a trust for his step-daughter. The knowledge that he was likely to have some significant tax obligation, even if the precise amount of that obligation was unknown, was sufficient for Mr. Vaughn to form a purposeful intent to conceal or dissipate his assets to evade or defeat his 1999 and 2000 tax obligations. This Court finds no clear error in these findings.

Accordingly, the Court AFFIRMS in the Bankruptcy Court's determination that Mr. Vaughn's tax debt for 1999 and 2000 is not dischargeable pursuant to 11 U.S.C § 523(a)(1)(C).

United States Bankruptcy Court, D. Colorado.

In re James Charles VAUGHN, Debtor.

James Charles Vaughn, Plaintiff,

v.

United States of America, Internal Revenue Service, Defendant.

Bankruptcy No. 06-18082 MER

Adversary No. 08-1095 MER.

December 28, 2011

Aaron A. Garber, Howard Gelt, Joseph J. Mellon, Lee M. Kutner, Denver, CO, for Plaintiff.

Colin C. Sampson, James E. Weaver, Karen L. Pound, U.S. Department of Justice, Washington, DC, for Defendant.

ORDER

MICHAEL E. ROMERO, Bankruptcy Judge.

This matter involves the rise and fall of James Vaughn, an obviously intelligent man who made an extremely unintelligent decision. Through hard work and entrepreneurial talent, he gained experience in the options trading, venture capital, and cable television industries, rising to executive positions in several companies. In 1995, he started a successful cable company and began acquiring small cable companies with an eye to selling to a larger entity. The venture was sold in 1999 for a gross sales price of $2.1 billion, of which Mr. Vaughn received approximately $34 million in cash and stock. Sadly, this inspiring business

success story then took a very negative turn when Mr. Vaughn made the investment which forms the subject of this action.

JURISDICTION

The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334(a) and (b) and 157(a) and (b). This is a core proceeding under 28 U.S.C. § 157(b)(2)(I) as it concerns the dischargeability of a particular debt.

BACKGROUND FACTS[1]

The Plaintiff in this action, James Charles Vaughn ("Vaughn"), graduated from high school in 1962. He completed some college courses, but did not earn a degree. Vaughn gained significant experience in business by working with several companies, primarily in the cable television industry. During the 1980s and 1990s, he served as the senior vice president of Triax Communications, a cable company, and was involved in budgeting, financial review, capital raising, acquisitions, and complex negotiations. During the time Vaughn was with Triax, it grew from 30,000 subscribers to approximately

[1] The background facts in this Order are taken from the testimony at trial, as well as exhibits and designated portions of depositions presented by the parties. In order to avoid a distracting number of footnotes, the Court will only insert a citation in reference to a specific document or where clarification is needed.

400,000 subscribers. In addition, early in his career, Vaughn began trading options and options futures. As he gained experience, he developed an understanding of the mechanics of investments.

In 1995, Vaughn started Frontier Vision Partners ("Frontier Vision"). He borrowed $500,000 from JP Morgan to start up the company. JP Morgan later invested an additional $25 million in the venture. Frontier Vision raised additional capital through Vaughn, JP Morgan agents, and from presentations to investors. Vaughn explained Frontier Vision's business model was to become a world cable television acquirer, with the intent to buy smaller companies and eventually sell them to a larger entity. To that end, Frontier Vision purchased rural cable television providers and consolidated them into a single provider.

When Frontier Vision began in 1995, it hired the international accounting firm KPMG, LLP ("KPMG") to review acquisition agreements, handle tax preparation and audit activities, document public bond offerings, and perform related services. Vaughn hired Mr. Jack Koo ("Koo"), an experienced commercial banker, as Frontier Vision's chief financial officer. Mr. James McHose ("McHose"), a certified public accountant previously employed by KPMG as a senior tax manager, was also hired by Frontier Vision as vice president and treasurer.

In early 1999, Frontier Vision was sold to Adelphia Communications Corporation ("Adelphia"). From

the sale, Vaughn received approximately $20 million in cash and $11 million in Adelphia stock. Koo also received significant cash and Adelphia stock from the sale.

Vaughn knew he would realize capital gains from the sale of Frontier Vision in excess of $30 million. Thus, after the sale was announced, McHose arranged meetings with financial advisors for Vaughn and Koo to suggest investment and tax strategies addressing their profits from the sale. In two meetings with KPMG partner Gary Powell ("Powell"), a product called Bond Linked Issue Premium Structure ("BLIPS") was presented as an investment possibility. The BLIPS product was offered by a company known as Presidio Advisory Services, LLC ("Presidio"). In August 1999, Vaughn, as a potential investor, was issued a "Confidential Memorandum" which described the BLIPS program in detail.

A. The BLIPS Program

In the Confidential Memorandum, Presidio described BLIPS as a three-stage, seven-year program comprised of investment funds, or investment pools. The first stage, to last 60 days, involved relatively low risk strategies, while the second stage, lasting 120 days, and the third stage, lasting six and one-half years, increased the risk on the investment with the potential for higher returns. Investors,

known as Class A members, could withdraw from the program after the first 60 days.[2] In general, this strategy focused on investing in foreign currencies, including currencies "pegged" to the United States dollar.[3] Specifically, these funds, in which a Class A member could invest through creation of a separate investment entity, would "invest in U.S. dollar and foreign currency denominated debt securities of corporate and governmental issuers and enter into forward foreign currency contracts, options on currencies and securities and other investments. . . ."[4] Stated simply, this was an investment which could make money based on the volatility of foreign currencies.

What made BLIPS a "tax strategy" was how the investment was to be funded. Generally, an investor would contribute a relatively modest amount compared to the amount ultimately invested. The balance of the investment would be funded through a loan. The loan would be somewhat unconventional because it would charge a high rate of interest and also carry what was referred to as an "initial unamortized premium amount," or loan premium. The loan premium created a lower, "market rate" of interest, by doing the following three things: 1) amortizing the

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[2] Joint Exhibit 3, Confidential Memorandum, pp. 7-8 and p. 15.

[3] Joint Exhibit 3, Confidential Memorandum, pp. 8-9.

[4] Joint Exhibit 3, Confidential Memorandum, p. 4 "Executive Summary."

loan premium; 2) paying interest on the loan amount; and 3) paying interest on the premium itself. Stated differently, while the aggregate of the loan and the loan premium was owed, the premium was being amortized as the loan went forward.[5]

The more important aspect of the investment would be the basis claimed by the taxpayer for such an arrangement. Under the BLIPS program, the taxpayer would claim a basis of the total amount contributed to the investment less the stated principal amount of the loan. As a result, the loan premium is added to the initial investor contribution. Thus, gains are protected by the high basis or, alternatively, in a case where a tax loss may be attractive, for a relatively little actual cash outlay, a claimed basis could result in a high tax loss "even though the taxpayer has incurred no corresponding economic loss."[6]

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[5] Testimony of Dr. David DeRosa ("DeRosa"). To show how this would work, DeRosa posited an investor who borrows $100 for a year at 6% simple interest, where the interest at the end of the loan term is thus $6, and the investor would owe $106 at the end of the year. If, on the other hand, the investor borrowed $60 for one year at 76.67% interest, and received a $40 premium, the interest at the end of the loan term would be $46, and the investor would owe $106. In each case, the investor receives $100 and owes $106 at the end of the year. According to DeRosa, the loan Vaughn received follows the same model as the second example, but over seven years rather than one year. *See* Internal Revenue Service ("IRS") Exhibit NNNNN.

[6] IRS Exhibit UUU, Internal Revenue Bulletin Notice 2000-44, p. 255.

B. The Investment

In July 1999, following their receipt of the Confidential Memorandum, Vaughn and Koo met with David Makov and Robert Pfaff of Presidio to discuss investments involving the Argentine Peso and the Hong Kong Dollar. The investments were to be accomplished through the creation of a fund called Sill Strategic Investment Fund ("Sill"), to which entities created by the individual investors would contribute funds through an account at Deutsche Bank AG ("Deutsche Bank"). Deutsche Bank would then provide loans for investments in the foreign currency markets through the BLIPS program.

Vaughn chose to invest in the BLIPS program, and in furtherance of this decision created an entity known as Pilchuck Ventures, LLC ("Pilchuck"). On October 7, 1999, pursuant to Presidio's instructions, Vaughn wired $2.8 million to the Pilchuck account at Deutsche Bank to commence the BLIPS transaction.[7] In Vaughn's case, the corresponding loan from Deutsche Bank would be $66 million, plus a $40 million "premium."[8]

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[7] Joint Exhibit 5.

[8] *See* Joint Exhibit 7H, formation documents for Pilchuck, p. 9, approving credit agreement with Deutsche Bank; Joint Exhibit 7B, Credit Agreement between Pilchuck and Deutsche Bank; and IRS Exhibit C, noting a $1 million loan premium assigned for each $700,000 contributed by an investor.

Vaughn received closing documents to be reviewed, signed, and returned.[9] The credit documents with Deutsche Bank were dated October 13, 1999. Sill was set up on October 22, 1999.[10] Presidio's letter to Vaughn of October 26, 1999 indicated Sill received contributions from Pilchuck on October 22, 1999 in a total amount of $109.5 million, which included the $2.8 million supplied by Vaughn and the amount loaned by Deutsche Bank.[11] On October 22, 1999, Deutsche Bank sent confirmation notices showing transactions involving approximately $107 million, primarily purchases of Argentine Pesos and Hong Kong Dollars.[12] [13]

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[9] *See* Joint Exhibits 7A-7L.

[10] Joint Exhibit 8.

[11] Joint Exhibit 12.

[12] Joint Exhibits 9, 10, and 11.

[13] Sill then proceeded to change the interest rate structure by engaging in a "swap" derivative transaction with Deutsche Bank, which lowered the rate to the more conventional London Interbank Offer Rate ("LIBOR") common in financial markets. Thus, Sill received, at least on paper, the 17.694% times $66.7 million, that is, the $66.7 million plus the $40 million. Since, following the swap, Sill had to pay LIBOR on the whole indebtedness, it becomes apparent the transaction is really a simple loan at LIBOR interest on $106.7 million. Because Sill was able to swap the 17.694% interest rate for interest at LIBOR, DeRosa stated the only purpose for the initial 17.694% interest rate was to amortize the $40 million and pay interest at market levels. Thus, after the contribution by Pilchuck, Sill now had a bargain rate, LIBOR, plus the $2.8 million put in by Vaughn, but the actual funds were still, and always were, physically held by Deutsche Bank.

On December 9, 1999, Vaughn received a report from Presidio showing a Pilchuck loss, as of December 8, 1999, of approximately $280,000.[14] Thereafter, as planned, Vaughn "pulled out" of the investment after approximately 60 days.[15] After deduction of fees and interest, Vaughn received approximately $900,000 back from his initial $2.8 million investment, comprised of U.S. dollars, Euros, and Adelphia stock.[16]

The large losses in the BLIPS transactions were generated because Pilchuck (and its sole owner, Vaughn) received only approximately $900,000 in returns on its investment, on a cost basis equal to the amount originally contributed by Vaughn, $2.8 million, plus the loan premium of $40 million, for a basis of approximately $43 million. Thus, a tax loss of approximately $42 million could potentially have been generated by this "investment."

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[14] Joint Exhibit 13.

[15] *See* IRS Exhibit HH, consisting of a letter from KPMG employee Robert Lees ("Lees") to Vaughn, dated December 16, 1999, confirming their discussion in which Vaughn directed KPMG to take steps to withdraw Pilchuck from Sill, and a withdrawal request signed by Vaughn and dated December 10, 1999.

[16] Vaughn initially stated he did not authorize the purchase of Adelphia stock as part of the ending of the BLIPS transaction, but, upon review of his earlier deposition testimony, concluded he misspoke.

C. The Tax Problem

Thereafter, Lees prepared Vaughn's 1999 tax return.[17] This return reflected certain of the losses generated by the BLIPS investment. According to Lees, he relied on the opinions of KPMG and the law firm of Brown & Wood in taking a loss on that return.[18] While Vaughn acknowledged the purpose of BLIPS was to generate losses to him of approximately $40 million, he noted the loss taken on his 1999 tax return did not reflect any real hard dollar loss to anybody at the time the return was filed. In fact, he had no actual losses in the amount claimed when the deduction was taken. He admitted he did not take the full amount of the BLIPS losses on his 1999 tax return. He did take sufficient tax losses to result in his reporting only a $2.4 million capital gain from the sale of Frontier Vision. However, he denied Powell instructed him to take less than the full loss to avoid arousing any IRS suspicions.

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[17] IRS Exhibit V.

[18] As part of the promotion of BLIPS, KPMG provided a "more likely than not" opinion letter to investors, in which KPMG stated its belief it was more likely than not the IRS would accept the validity of the investment program. On March 23, 2000, Powell sent Vaughn ten pages of KPMG's opinion letter; after Vaughn had signed off on those pages, Powell provided the full opinion letter, dated December 31, 1999. Further, for an additional fee of approximately $50,000, Vaughn also received a similar opinion letter from the law firm of Brown & Wood, a firm engaged by KPMG, dated December 31, 1999. Joint Exhibit 19. However, Powell did not send Vaughn the Brown & Wood letter until May 24, 2000.

On September 5, 2000, the IRS issued Internal Revenue Bulletin Notice 2000-44 addressing tax avoidance using artificially high basis.[19] That Notice stated in part:

Under the position advanced by the promoters of this arrangement, the taxpayer claims that only the stated principal amount of the indebtedness, $2,000X in this example, is considered liability assumed by the partnership that is treated as a distribution of money to the taxpayer that reduces the basis of the taxpayer's interest under § 752 of the Internal Revenue Code. Therefore, disregarding any additional amounts the taxpayer may contribute to the partnership, transaction costs, and any income realized or expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the excess of cash contributed over the stated principal amount of the indebtedness, even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. In this example, the taxpayer purports to have a basis of $1,000X (the excess of cash contributed ($3,000X) over the stated principal amount of the indebtedness ($2,000X)). On disposition of the partnership interest, the taxpayer claims a tax loss with respect to that basis amount,

[19] IRS Exhibit UUU.

even though the taxpayer has incurred no corresponding economic loss.[20]

KPMG determined BLIPS investors should be contacted regarding the Notice. Specifically, Mr. Jeffrey Eischeid, a KPMG employee, through an email to Powell dated October 3, 2000, provided a script to be used in conversations with such clients and specifically identified Vaughn and Koo as investors who should be contacted.[21] Vaughn did not recall attending a meeting with representatives of KPMG regarding Notice 2000-44, but Lees thought there may have been such a meeting on January 21, 2001, and remembered KPMG representatives continued to insist the transaction was legitimate and would back the transaction and fight the IRS on its interpretation.[22] It is not clear whether, in any such meeting, Vaughn was informed of the increased likelihood of audit or the increased possibility KPMG would be required to provide to the IRS the names of clients engaged in transactions similar to those described in the Notice.[23] On February 6, 2001, Lees sent a letter

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[20] *Id.,* p. 255.

[21] Vaughn Exhibit 24.

[22] Joint Exhibit 20.

[23] *See also* Vaughn Exhibit 27, Memorandum of Oral Advice, dated March 25, 2002, signed by Tracy Henderson, another KMPG employee, commemorating the January 2001 meeting with Powell, Koo and Vaughn. Vaughn could not remember this meeting; however, he points out the Memorandum does not contain the paragraph in the script provided to Powell on

(Continued on following page)

to Vaughn containing a copy of Notice 2000-44. Vaughn could not remember receiving this document.

On February 6, 2002, Victoria Sherlock ("Sherlock"), a KPMG in-house attorney, met with Koo and Vaughn to discuss an IRS settlement initiative, Notice 2002-2. Sherlock represented Koo, who had received an audit letter from the IRS in 2001 regarding his BLIPS investment. Koo stated he had not had much contact with Vaughn during 2001, and first informed him of his audit letter at the February 6, 2002 meeting. At this meeting, Sherlock, without making a representation about whether she believed BLIPS would ultimately result in additional taxes, informed Vaughn he should disclose his participation in BLIPS to the IRS.[24] Vaughn's disclosure was provided to the IRS on or about March 28, 2002.[25] Vaughn also provided other information requested by the IRS, and agreed to extensions of the statute of limitations to allow the IRS to continue its investigation concerning the losses on his 1999 tax return.

In May 2002, Vaughn and his then-wife Cindy Vaughn received letters from the IRS scheduling an appointment to examine their 1999 tax returns.[26] On March 18, 2004, Lees filed amended tax returns for

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October 3, 2000, indicating such probabilities had been discussed.

[24] Sherlock Deposition, pp. 54 and 67.

[25] Joint Exhibit 25.

[26] Joint Exhibit 26.

the Vaughns for 1997, 1998 and 1999, adding a net operating loss carryback incurred by Vaughn in 2003.[27]

On May 24, 2004, the IRS issued Announcement 2004-46, the so-called "Son of Boss Settlement Initiative."[28] Vaughn asserts he was aware by this time of misrepresentations and omissions made by KPMG and Presidio, through conversations with his attorney, with Koo and through review of a widely-known Senate Subcommittee Report critical of investment vehicles such as BLIPS.[29] Specifically, Vaughn claims KPMG and Presidio hid information from their clients, made misrepresentations about the economic substance and leverage in investments, and misrepresentations about the validity of opinion letters. Vaughn mailed a Notice of Election to Participate in the Announcement 2004-46 Settlement Initiative on

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[27] IRS Exhibit XX.

[28] Vaughn Exhibit 47, IRS Announcement 2004-46, "Son of Boss Settlement Initiative." The essence of this proposal by the IRS was to resolve the transactions described in IRS Notice 2000-44, like BLIPS, by allowing taxpayers to concede tax benefits from the transactions, including basis adjustments, and to treat their net out of pocket costs as either long term capital losses or ordinary losses. Taxpayers who participated in the initiative were required to make full payment of the liabilities under the initiative by the date the agreement with the IRS was executed.

[29] Vaughn Exhibit 38, United States Senate Report entitled "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals – Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2".

June 21, 2004. On June 24, 2004, Vaughn received a notice of deficiency showing taxes for the tax year ended December 31, 1999, in the sum of $8,617,902 ("the 2004 Assessment").[30] He could not pay these taxes within thirty days, and so could not meet the eligibility requirements of the Settlement Initiative.[31]

On November 3, 2006, Vaughn filed his Chapter 11 petition (the "Petition Date"). The IRS filed a proof of claim for $14,359,592 as a general unsecured claim, stating at that time the taxes were not entitled to priority under 11 U.S.C. § 507(a)(8)(A)[32] because they were assessed more than 240 days before the Petition Date. Almost a year after the Petition Date, and three years after the 2004 Assessment, the IRS

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[30] Joint Exhibit 29. The liability was the result of conclusion of the IRS that the claimed basis for Vaughn's BLIP investment was too high – the $40 million loan premium should not have been included because that obligation was taken over by Sill and never represented funds paid by Pilchuck or Vaughn. *See* IRS Exhibit UUU, p. 3, IRS Notice 2000-44, "Tax Avoidance Using Artificially High Basis." As noted above, this Notice describes an example similar to the BLIPS transaction described here, and notes the taxpayer would claim a basis of the total amount contributed to the investment (in this case, $106.7 million) less the stated principal amount of the loan (in this case $66.7 million) for a basis (in this case $44 million) "even though the taxpayer has incurred no corresponding economic loss." The Notice goes on to state the purported losses from such a transaction "do not represent bona fide losses reflecting actual economic consequences as required for purposes of [26 U.S.C.] § 165."

[31] Vaughn Exhibit 45, IRS Announcement 2004-46 p. 2.

[32] Unless otherwise noted, all future statutory references in the text are to Title 11 of the United States Code.

realized its error. On October 29, 2007, the IRS abated the 2004 Assessment as unlawful, and on April 10, 2008, the IRS filed its amended proof of claim, asserting the taxes were entitled to priority.

ISSUES AT TRIAL AND THE PARTIES' POSITIONS

Before the Court is the determination of the dischargeability of the 2005 assessments for the 1999 and 2000 taxes.[33] Critical to this determination is whether Vaughn 1) made a fraudulent return; or 2) willfully attempted in any manner to evade or defeat tax for years 1999 and 2000, pursuant to § 523(a)(1)(C).

Vaughn seeks a finding the taxes assessed against him prepetition, which were abated post-petition and which will be reassessed postpetition, are dischargeable under §§ 105, 523(a), and 507(a)(8). Specifically, Vaughn alleges KPMG and its agents abused their fiduciary relationship with Vaughn by approaching and pressuring him to invest in BLIPS. Vaughn further asserts because of Koo's financial expertise, he reasonably relied on Koo's advice and representations by KPMG, Koo, and attorneys engaged by KPMG. Vaughn thus did not perform much,

[33] The Court's record reflects the IRS's tax claim arises from unpaid taxes for 1999 in the amount of $8,617,902, and for 2000 in the amount of $119,928.

if any, personal due diligence of the BLIPS program.[34] When Koo determined there was economic substance to the BLIPS investment, and based on KPMG's promises, Vaughn invested. Finally, he notes he was also distracted by his wife's serious medical problems at the time.

Vaughn contends KPMG committed fraud because it misrepresented the nature of the BLIPS transaction and did not timely provide promised opinion letters – not until after the investment was made.[35] In addition, Vaughn asserts KPMG knew the investments and that it was being investigated by the Senate for its involvement in the BLIPS program, but did not timely disclose this information to him.

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[34] Vaughn admitted the following key language in KPMG's engagement letter was incorrect: "Client [Vaughn] has independently determined that there is a reasonable opportunity for Client to earn a reasonable pre-tax profit from the [BLIPS] Investment Program in excess of all associated fees and costs."

[35] Specifically, Vaughn testified representatives from KPMG did not tell him KPMG's opinion letter was predicated on Vaughn's own representations about BLIPs, and that KPMG and Presidio representatives told him there was a reasonable possibility of a pre-tax profit from BLIPS. (However, as noted below, he did "sign off" on representations before receiving the final version of the KPMG opinion letter.) He further stated he did not receive the hundreds of pages of loan documents to be reviewed and signed until a few days before closing. With respect to KPMG's opinion letter, Vaughn stated he did not receive anything until March 23, 2000, when Powell sent him the first ten pages of the opinion letter and requested he "sign off" on them in order to receive the full opinion letter. *See* Joint Exhibit 17.

Vaughn therefore states he did not willfully evade taxes either through the filing of his tax return or his actions following the filing of the tax return because he was counseled by KPMG that the transaction was legitimate and would ultimately be approved by the IRS.

The IRS asserts the tax assessments are non-dischargeable under § 523(a)(1)(C). According to the IRS, Vaughn willfully attempted to evade his tax obligations for 1999 and 2000, and filed fraudulent returns for those years. The IRS states Vaughn knew or should have known, and in reckless disregard of the information that would have informed him, that BLIPS provided him with no reasonable opportunity to earn a reasonable pre-tax profit. He also knew or should have known BLIPS would not survive IRS scrutiny. The IRS contends Vaughn and Koo were too sophisticated to believe BLIPS was legitimate.

Moreover, in contrast to Vaughn's arguments, the IRS points out on March 24, 2000, Vaughn signed off on the draft opinion letter to Pilchuck which KPMG planned to issue regarding BLIPS.[36] The cover letter to the draft, signed by Gary Powell, directed Vaughn to sign the last page of the draft indicating Vaughn had read the draft letter and agreed with its contents. The IRS states Vaughn's representations in this letter were false, and Vaughn knew the BLIPS investment had no reasonable prospect for earning a pre-tax

[36] Joint Exhibit 17.

profit, and, contrary to the letter, there was no economic reason for borrowing funds from Deutsche Bank at an excessive interest rate.

In addition, the IRS states Vaughn sought to conceal the BLIPS losses from the IRS by directing Presidio to cause Sill to purchase Euros and Adelphia stock in order to attach most of his tax losses to shares of Adelphia.[37] According to the IRS, the Euros and Adelphia stock were purchased in such a fashion that the tax basis of approximately $40 million could be allocated, once Pilchuck had withdrawn from Sill, 8% to Euros and 92% to a capital asset – the stock.[38] Moreover, the IRS states Vaughn evaded taxes associated with the sale of his company by transferring assets to family members and spending enough to reduce the value of his estate to far less than his taxes.

DISCUSSION

Section 523(a)(1) provides:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt –

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[37] *See* IRS Exhibit HH, Annex A, signed by Vaughn, withdrawing Pilchuck's capital account balance from Sill and directing the purchase of Euros and shares of Adelphia stock.

[38] *Id.,* p. 3, Information Sheet containing instructions for allocation of "total notional" of $40,000,000 after withdrawal of Pilchuck from Sill.

(1) for a tax or a customs duty –

(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, or equivalent report or notice, if required –

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax . . . [39]

This subsection, to be read in the disjunctive, thus contains two separate exceptions to discharge: 1) for making a fraudulent return; and 2) for willfully attempting to defeat and evade tax.[40] The IRS admits it bears the burden of proving the tax debts should be excepted from discharge by a preponderance of the evidence.[41]

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[39] 11 U.S.C. § 523(a)(1).

[40] *See In re Tudisco,* 183 F.3d 133, 137 (2d Cir.1999); *In re Epstein,* 303 B.R. 280 (Bankr.E.D.N.Y.2004).

[41] *Grogan v. Garner,* 498 U.S. 279, 291, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991).

A. Filing a Fraudulent Return

This Court can find no cases from the Tenth Circuit Court of Appeals discussing what constitutes a fraudulent return under § 523(a)(1)(C). The issue has been addressed, however, by other courts in this Circuit. These courts have focused on 1) knowledge of the falsehood of the return; 2) an intent to evade taxes; and 3) an underpayment of the taxes, items which have come to be referred to as the "*Krause*" factors.[42] These courts have also set forth additional "badges of fraud" signaling a fraudulent return, including: 1) consistent understatement of income; 2) failure to maintain adequate records; 3) failure to file tax returns; 4) implausible or inconsistent behavior by a debtor; 5) concealing assets; 6) failure to cooperate with taxing authorities; and 7) unreported income from an illegal activity.[43]

The facts set forth above lead to the conclusion Vaughn knew or should have known the returns he filed in 1999 and 2000 contained false information. Specifically, after receiving approximately $34 million in cash and stock from the sale of his company, he invested, through creation of Pilchuck, in a risky and

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[42] *Wilson v. United States,* 394 B.R. 531, 540-541 (Bankr.D.Colo.2008), *rev'd in part on other grounds,* 407 B.R. 405 (10th Cir. BAP 2009) (citing *United States v. Krause (In re Krause),* 386 B.R. 785, 825 (Bankr.D.Kan.2008) (collecting cases)). *See also In re Fliss,* 339 B.R. 481, 486 (Bankr.N.D.Iowa 2006); *In re Schlesinger,* 290 B.R. 529, 536 (Bankr.E.D.Pa.2002).

[43] *Krause,* 386 B.R. at 824 (citations omitted).

complex transaction promoted by KPMG. He did not conduct his own investigation regarding the nature of the investment nor its tax consequences. Rather, he asserts he relied on the representations of KPMG, of KPMG's attorneys, and of Koo after Koo had reviewed the information supplied by KPMG. Unfortunately for him, Vaughn signed several documents expressly representing he had made an independent investigation. Moreover, he knew, at least by the time he filed the 1999 and 2000 tax returns, the investment was considered suspect by the IRS, and was being investigated. He further acknowledges he now believes the investment had no economic basis.

The evidence makes clear Vaughn was, and is, a sophisticated businessman. What he may lack in formal education, he made up for with hard work, long experience, and intelligence, enabling him to build organizations and eventually create a business which he sold for $2.1 billion. He is a self-made, successful entrepreneur whose accomplishments merit admiration and respect. It is simply not credible such an individual would enter into a transaction like BLIPS without making an independent investigation. Nor it is credible a savvy businessman like Vaughn would not have identified the numerous red flags associated with the transaction – red flags

suggesting the investment strategy was not sound and might be an abusive tax shelter.[44]

As his defense, Vaughn seeks to convince this Court he relied on the misrepresentations of others. The Court recognizes KPMG, KPMG's attorneys, and others who may have made representations to Vaughn about BLIPS can certainly be argued to have committed malfeasance. However, it is simply not believable that a man of Vaughn's experience and business acumen would risk endangering what at that time must have been the financial culmination of his career, the $34 million from the sale of his company, without much more personal involvement and a true independent investigation. It is not credible Vaughn could have failed to recognize a representation by KPMG, the promoter of the BLIPS program, or a representation by the lawyers hired by KPMG, might not constitute a truly unbiased opinion or serve as independent investment advice. As the promoter of BLIPS, KPMG and anyone working for KPMG had an inherent conflict of interest when rendering an opinion on BLIPS. Further, even though it stood to gain fees, the attorneys hired by KPMG to issue "opinion letters" only felt comfortable issuing such a letter

[44] Such "warning signals" include the overly complex nature of the Deutsche Bank loan, the reliance on a "loan premium" not contributed by Vaughn to create a tax basis for the investment and KPMG's requirements for Vaughn to state, by signing a draft, that he agreed with KPMG's opinions, before KPMG would issue its actual opinion.

with the conclusion that BLIPS stood at least a 50% chance of being disallowed by the IRS. For these reasons, the Court finds Vaughn knew or should have known BLIPS-related losses were improper to claim as an offset against taxes he owed on his income from selling his company, thus meeting the first prong of the *Krause* test.

For these same reasons, the Court questions Vaughn's position he viewed BLIPS primarily as an investment versus a tax savings vehicle. According to DeRosa, the IRS's expert witness, BLIPS could not reasonably have generated any gains for investors. DeRosa analyzed the currency transactions engaged in by Sill, and pointed out they had no economic impact. For example, Sill initially bought Euros on a "spot" transaction with the dollars and simultaneously sold the Euros "forward" one month.[45] Such "short forward" transactions simply "washed out" at the U.S. dollar interest rate, and did not constitute meaningful economic transactions because there was no economic risk and the money never left Deutsche

[45] DeRosa explained a spot transaction is one which settles in two bank business days, with the last day, or "settlement day" as the day the currencies are valued. A forward transaction, by contrast, is one where the "settlement day" of the currency to be valued is beyond two days-anywhere from a week to any time in the future. A forward transaction is based on the difference of between one currency and the other, and because of differentials in interest rates, the forward rate cannot equal the spot except if the interest rates in both countries are equal to each other at that moment in time.

Bank. In DeRosa's opinion, there was no prospect of making any money other than interest on such transactions.[46] Sill also obtained "forward" positions with Hong Kong Dollars and Argentine Pesos. DeRosa stated these transactions were really a short-term bet the currencies would collapse and be worth much less in, for example, sixty days, when an investor would be able to buy back U.S. Dollars with significantly less valuable Hong Kong Dollars or Argentine Pesos.

DeRosa opined the problem with this strategy was the Hong Kong Dollar and the Argentine Peso in 1999 were extremely stable, with little to no chance of devaluation or collapse. He noted because the Hong Kong Dollar and the Argentine Peso are "hard pegged" to the U.S. Dollar, they are among the least volatile currencies.[47] They have traditionally been

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[46] DeRosa stated eventually, however, even in this "zero sum" game, interest parity will cost money over time, eroding the original investment. Specifically, according to DeRosa, under John Maynard Keynes's theory of interest parity, there are no free transactions. The "forward" is the same as the "spot" adjusted for the interest rate differential during the term of the transaction. In other words, the "forward" amount will differ from the "spot" amount by the gap in the interest rate – otherwise, an investor could make money simply by switching investments to the highest interest currency. DeRosa stated if an investor is "shorting" a currency like the Hong Kong Dollar or the Argentine Peso, the investor will pay, implicit in the price of the "forward," a higher interest rate than the U.S. Dollar rate, creating a "cost of carry" which eats away at the investor's position over time.

[47] A "pegged" currency means the exchange rate with other currencies is fixed by a country's central bank. Some are called

(Continued on following page)

stable even when other currencies fell in value. Therefore, there was virtually no possibility of an economic return on this transaction. To obtain one, according to DeRosa, Vaughn would have had to realize an unrealistic return of 67% on his $2.8 million – in DeRosa's opinion, an impossible hurdle in 60 days.

DeRosa also noted the crippling restrictions placed on Sill by Deutsche Bank in their agreement. The investments Sill could make were extremely limited, and Deutsche Bank, according to DeRosa, could liquidate Sill's positions essentially at will. Deutsche Bank also reduced the possibility of gain by charging fees based on forecasts of Sill's portfolio fluctuation, the so-called "value at risk haircut." Deutsche Bank further retained the right to call the loan if the value of the portfolio dropped below $108,033,750, or 101.25% of the $106.7 million funding amount, which, in DeRosa's opinion, meant Sill could not invest in anything that would make money because it was prevented from taking any risks.[48]

"soft pegs" because the government intends to keep the exchange rate fixed but could change the rate at any time. Some are "hard pegged," which means the central bank of a country keeps on hand enough reserves of foreign currency, usually U.S. dollars, to exchange all of its currency in circulation at a fixed price, and promises to make a market continuously. Two hard pegged currencies, for purposes of this case, were the Hong Kong Dollar and the Argentine Peso.

[48] Moreover, DeRosa noted the cost of leaving the investment after 60 days, even though that was what Vaughn anticipated,

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Vaughn must have been aware of these "limitations" in light of his experience. Thus the Court finds Vaughn cannot have made the BLIPS investment because he thought it would be a way, even a risky way, to make money. He was simply too smart a businessman for that. Therefore, he must have had another motivation for placing approximately $2.8 million into BLIPS. Based upon the returns he filed, which showed significant tax losses, and based upon his testimony the returns were structured to show a small net capital gain rather than showing the entire amount of BLIPS losses, the Court concludes his motivation in making the BLIPS investment and filing tax returns using the losses from the BLIPS investment was designed to evade taxes on the income from the sale of his company. Accordingly, the second *Krause* prong (intent) is met.

As to the third prong, it should be noted Vaughn himself testified he underpaid the taxes, and has repeatedly expressed his intention to pay them. His dispute is with the assertion he knew of the impropriety of the BLIPS investment at the time it was made, or at the time he filed his 2004 amendment to his 1999 return. He contends he did not know of the

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was high, due to breakage fees and other penalties. Further, he pointed out the other fees associated with the transaction, including $1.1 million to Presidio and $500,000 to KPMG, did not make sense because an investor who could establish an account with approximately $1 million could have made the same trades without the Sill investment scheme.

true nature of the investment until much later. Because the Court finds, as described above, he knew or should have known about the problems with BLIPS at the time of the investment, the Court concludes this argument lacks merit. In addition, when he filed his amended 1999 return in 2004, he was aware KPMG was under investigation, and Mr. Lees told him in early 2001 the BLIPS losses would be disallowed. Therefore, the taxes were clearly underpaid and the third prong of the *Krause* test has been met.

The Court notes the other "badges of fraud" signaling a fraudulent return set forth in *Krause,* such as failure to keep records and failure to file returns, are not present. However, the "badge" of implausible and inconsistent behavior exists. Vaughn's general investment manager, Robert Mueller, with whom he placed other investments, described Vaughn as a conservative investor who had never shown any interest in or knowledge of foreign currency based investments.[49] Thus, Vaughn's actions involving the BLIPS investment were inconsistent both with his other investment behaviors, and were both implausible and inconsistent with his business acumen and purported investment goals.

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[49] Mueller Deposition, p. 32, lines 19-20, and p. 36, lines 13-25.

B. Willful Evasion

The most recent appellate decision addressing § 523(a)(1)(C) identified two components to a showing of willful evasion: 1) a conduct requirement; and 2) a mental state requirement.[50] The Court stated:

To satisfy the conduct requirement, the government must demonstrate that the debtor avoided or evaded payment or collection of taxes through acts of omission, such as failure to file returns and failure to pay taxes, or through acts of commission, such as affirmative acts of evasion. Non-payment of tax alone is not sufficient to bar discharge of a tax obligation, but it is a relevant consideration in the overall analysis.

. . . .

[In addition] non-dischargeability under 523(a)(1)(C) requires a "voluntary, conscious, and intentional evasion." The government must prove that the debtor 1) had a duty to pay taxes, 2) knew she had a duty, and 3) voluntarily and intentionally violated that duty.[51]

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[50] *United States v. Storey,* 640 F.3d 739, 744 (6th Cir.2011). *See also United States v. Jacobs, (In re Jacobs),* 490 F.3d 913, 921 (11th Cir.2007); *United States v. Fegeley (In re Fegeley),* 118 F.3d 979, 983 (3rd Cir.1997).

[51] *Storey,* 640 F.3d at 744-745 (citations omitted).

1. Conduct

A recent case observed when a debtor affirmatively acted to avoid payment or collection of taxes, whether through commission or omission, these actions satisfy the conduct requirement of willful evasion of tax.[52] The *Hawkins* court noted: "[L]arge discretionary expenditures, combined with nonpayment of a known tax, contribute to the conduct analysis. Moreover, nonpayment of a tax can satisfy the conduct requirement when paired with even a single additional culpable act or omission."[53] The *Hawkins* court went on to affirm the bankruptcy court's finding a debtor met the conduct requirement of § 523(a)(1)(C) where he made "unreasonable and unnecessary discretionary expenditures at a time when he knew he owed taxes and knew he would be unable to pay those taxes."[54]

Here, Vaughn admitted as of June 2001, he knew Koo was subject to an IRS audit regarding the BLIPS transaction. In addition, by January 2001, he was informed of the IRS notice questioning the validity of BLIPS by receiving a copy of the Notice 2000-44. He was also in possession of the opinion letter indicating

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[52] *Hawkins v. Franchise Tax Bd.,* 447 B.R. 291, 301 (N.D.Cal.2011) (citing *Jacobs,* 490 F.3d at 921).

[53] *Id.,* at 301-302 (citing *Jacobs,* 490 F.3d at 926-27; *Gardner,* 360 F.3d at 560-61; *Fegeley,* 118 F.3d at 984; *United States v. Fretz (In re Fretz),* 244 F.3d 1323, 1329-30, *Toti v. United States (In re Toti),* 24 F.3d 806, 809 (6th Cir.1994)).

[54] *Id.,* at 302.

he could be subject to an audit on the same basis. He therefore knew he had a potential liability on the full amount of his gain from the Frontier Vision sale. Nonetheless, although he had transferred approximately one-half of his post-Frontier Vision sale assets to Cindy Vaughn as part of their divorce settlement, he failed to take any actions to preserve his remaining assets for the payment of additional taxes.

Specifically, he purchased a $1.7 million home in Evergreen, Colorado, but put the title in the sole name of his then-fiancee, Kathy St. Onge ("St. Onge"). Moreover, shortly before disclosing his participation in BLIPS to the IRS, Vaughn created and funded a $1.5 million trust for his stepdaughter, Stephanie Frank ("Frank"). In addition, after Vaughn married St. Onge in October, 2001, St. Onge obtained funds of approximately $97,000 from the couple's accounts, spent funds to decorate the Evergreen home, and spent $42,000 on jewelry.[55] Between 2002 and 2003, Vaughn himself spent approximately $20,000 on jewelry.[56] Even if Vaughn himself did not retain access to the funds he spent after knowing of his large potential tax liability, his transfers ensured funds would not be available to satisfy his tax obligations.

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[55] IRS Exhibit KKK.

[56] IRS Exhibit NNN.

2. Mental State

The *Jacobs* and *Hawkins* courts also summarize the case law interpreting the mental state component of willful evasion, noting the requirement is satisfied where the government shows the following three elements: 1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty.[57] The government does not need to demonstrate fraudulent intent, but only that a debtor acted "knowingly and deliberately."[58]

Similarly, the Tenth Circuit has held a debtor's actions are willful under § 523(a)(1)(C) if they are done voluntarily, consciously, or knowingly and intentionally.[59] It agrees with other courts that more than non-payment of one's taxes is required to establish a willful evasion.[60] However, the Tenth Circuit also noted concealment of assets to avoid payment or collection of taxes may constitute a willful evasion.[61] Indeed, the Tenth Circuit recognized "Congress did not define or limit the methods by which a willful

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[57] *Id.,* at 300; *Jacobs,* 490 F.3d at 921.

[58] *United States v. Mitchell (In re Mitchell),* 633 F.3d 1319, 1328 (11th Cir.2011).

[59] *Dalton v. Internal Revenue Service,* 77 F.3d 1297, 1302 (10th Cir.1996) (citing *Toti,* 24 F.3d at 809).

[60] *Id.,* at 1307.

[61] *Id.*

attempt to defeat and evade might be accomplished. . . ."[62] The Court also stated:

By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal.[63]

In addition, the United States District Court for the District of Massachusetts observed:

Conduct that constitutes circumstantial evidence of a debtor's willful intent to evade taxes includes: 1) implausible or inconsistent explanations of behavior, 2) inadequate financial records, 3) transfers of assets that greatly reduce assets subject to IRS execution and 4) transfers made in the face of serious financial difficulties.[64]

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[62] *Id.* at 1301.

[63] *Id.,* at 1301.

[64] *United States v. Beninati,* 438 B.R. 755, 758 (D.Mass.2010) (citations omitted). *See also, Geiger v. Internal Revenue Service (In re Geiger),* 408 B.R. 788, 791 (C.D.Ill.2009) (citations omitted).

In this case, as noted above, Vaughn exhibited behavior which was inconsistent with his business acumen and was implausible based on that acumen when he participated in the BLIPS investment. Further, by purchasing expensive homes, automobiles, and jewelry, following a divorce which significantly depleted his assets, he further demonstrated such inconsistent and implausible behavior. That is, knowing, as he must have, the BLIPS investment constituted an improper abusive tax shelter with no economic basis and no reasonable expectation of profit, he nonetheless continued to spend as if there would be no additional tax to pay. This is simply not logical, unless he had another motive for such spending.

The evidence before the Court not only demonstrates he spent the funds and made the transfers in the face of serious financial difficulties, but also indicates his motive in doing so was to reduce assets subject to potential IRS execution. In short, by transferring funds and assets to St. Onge and Frank, he attempted to take those funds and assets out of the reach of the IRS. The Court does not deny Vaughn may have had some altruistic goals in setting up a trust for Frank, and may have had some good intentions for transferring real property to and purchasing real property for St. Onge, but any such motivations are overshadowed and outweighed by the fact Vaughn knew of the impending tax debt, and took no reasonable actions to preserve assets to pay it.

In order to meet the requirements of § 523(a)(1)(C), a debtor need not exhibit fraud or an evil motive. Rather, choosing to satisfy other obligations or pay for non-essentials, while not paying taxes, sufficiently demonstrates intent to evade tax.[65] The United States District Court for the Northern District of California, in affirming the *Hawkins* decision, stated:

This statement adequately places debtors on notice that their decision to prioritize other obligations or make non-essential purchases, rather than pay a known tax debt, can render their tax debts nondischargeable. Following the reasoning of other courts that have addressed the issue, the Court adopts this standard and affirms the bankruptcy court's conclusion that unnecessary expenditures combined with nonpayment of a known tax constitutes a willful attempt under Section 523(a)(1)(C).[66]

This Court agrees with the reasoning set forth in these cases. Therefore, the Court finds Vaughn's

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[65] *Hawkins v. Franchise Tax Board (In re Hawkins),* 430 B.R. 225, 235 (Bankr.N.D.Cal.2010), *aff'd.,* 447 B.R. 291 (N.D.Cal.2011) (citing *Lynch v. U.S. (In re Lynch),* 299 B.R. 62, 64 (Bankr.S.D.N.Y.2003); *Jacobs,* 490 F.3d at 925-27; *Stamper v. United States, (In re Gardner),* 360 F.3d 551, 560-61 (6th Cir.2004); *Wright v. Internal Revenue Service (In re Wright),* 191 B.R. 291, 293 (S.D.N.Y.1995); *Hamm v. United States (In re Hamm),* 356 B.R. 263, 285-86 (Bankr.S.D.Fla.2006)).

[66] *Hawkins, supra,* 447 B.R. at 297.

actions meet the state of mind test to show intent to evade tax.

CONCLUSION

Throughout this case, Vaughn has argued he is an innocent victim of the machinations and misrepresentations of KPMG and persons in the employ of or hired by KPMG. This Court does not disagree that such machinations and misrepresentations took place. However, a taxpayer cannot reasonably rely on the advice of a professional who has an inherent conflict of interest, such as the promoter or marketer of a tax investment.[67] KPMG, its employees, and even the law firm employed by KPMG to issue "opinion letters" had such a conflict, because KPMG was the marketer of the BLIPS investment. It is simply not credible that an individual of Vaughn's extensive business background and demonstrated business skill would have reasonably relied on any such representations, and would not have, if he were seriously considering BLIPS as a legitimate investment, obtained a truly independent opinion as to its potential and its tax implications.

For these reasons,

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[67] *See Goldman v. C.I.R.,* 39 F.3d 402, 408 (2nd Cir.1994) (taxpayers "cannot reasonably rely for professional advice on someone they know to be burdened with an inherent conflict of interest.").

IT IS ORDERED Vaughn's tax debts arising from the sale of Frontier Vision are not dischargeable under 11 U.S.C. § 523(a)(1)(C).

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

In re: JAMES CHARLES VAUGHN, Debtor. ---------- JAMES CHARLES VAUGHN, Appellant, v. UNITED STATES OF AMERICA INTERNAL REVENUE SERVICE, Appellee.	No. 13-1189

ORDER

(Filed Oct. 30, 2014)

Before TYMKOVICH, McKAY, and MATHESON, Circuit Judges.

Appellant's petition for rehearing is denied.

The petition for rehearing en banc was transmitted to all of the judges of the court who are in regular active service. As no member of the panel and no

judge in regular active service on the court requested that the court be polled, that petition is also denied.

Entered for the Court

/s/ Elisabeth A. Shumaker

ELISABETH A. SHUMAKER, Clerk

United States Court of Appeals, Ninth Circuit

William M. Hawkins, III, AKA Trip Hawkins, Appellant,

v.

The Franchise Tax Board of California; United States of America, Internal Revenue Service, Appellees.

No. 11-16276

September 15, 2014

Argued and Submitted November 6, 2013; San Francisco, California

Appeal from the United States District Court for the Northern District of California, Jeffrey S. White, District Judge, Presiding. D.C. No. 3:10-cv-02026-JSW.

Heinz Binder (argued) and Wendy Watrous Smith, Binder & Malter, LLP, Santa Clara, California, for Appellant.

Kathryn Keneally, Assistant Attorney General, Kathleen E. Lyon, Bruce R. Ellisen, William Carl Hankla, and Rachel I. Wollitzer (argued), Attorneys, Tax Division, United States Department of Justice, Washington, D.C., for Appellee United States.

Lucy Wang, California Department of Justice, San Francisco, California, for Appellee State of California.

A. Lavar Taylor, Attorney and Adjunct Professor of Law, Chapman University School of Law, Santa Ana, California, for Amicus Curiae A. Lavar Taylor.

Before: Andrew J. Kleinfeld, Sidney R. Thomas, and Johnnie B. Rawlinson, Circuit Judges.

OPINION

THOMAS, Circuit Judge

In this case, we consider what mental state is required in order to find that a bankruptcy debtor's federal tax liabilities should be excepted from discharge under 11 U.S.C. § 523(a)(1)(c) because he "willfully attempted in any manner to evade or defeat such tax." Consistent with similar provisions in the Internal Revenue Code, 26 U.S.C. § 7201, we conclude that specific intent is required for the discharge exception to apply and remand to the district for re-evaluation under that standard.

I

F. Scott Fitzgerald observed early in his career that the very rich "are different from you and me,"[1] to which Ernest Hemingway later rejoined, "Yes, they have more money."[2] As with many bankruptcy cases

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[1] F. Scott Fitzgerald, *The Rich Boy, in* The Short Stories of F. Scott Fitzgerald: A New Collection 317 (Matthew J. Bruccoli ed., Scribner 1989) (1926).

[2] Ernest Hemingway, *The Snows of Kilimanjaro, in* The Snows of Kilimanjaro and other Stories 23 (Scribner 1961) (1936). (Hemingway, quoting the critic Mary Colum without attribution, used Fitzgerald's name in the original magazine version of the short story, but altered the name to "Julian" in the

(Continued on following page)

involving the wealthy, our saga reads like a Fitzgerald novel, telling the story of acquisition and loss of the American dream, and the consequences that follow.

William M. "Trip" Hawkins designed and received an undergraduate degree in Strategy and Applied Game Theory from Harvard University, and an M.B.A. from Stanford University. After college, he became one of the earliest employees at Apple Computer, where he ultimately became Director of Marketing. He left Apple to co-found Electronic Arts, Inc. ("EA"), which became the world's largest supplier of computer entertainment software. Hawkins owned 20% of EA and served as its Chief Executive Officer. By 1996, his net worth had risen to $100 million. That year, he divorced his first wife, Diana, and married his second wife, Lisa. Tripp and Lisa purchased a $3.5 million home, where she cared for their two children and Tripp's two children from his first marriage. The IRS asserts they enjoyed the trappings of wealth, such as a private jet, expensive private schooling for the children, an ocean-side condominium in La Jolla, and a large private staff.

In 1990, EA created a wholly owned subsidiary, 3DO, for the purpose of developing and marketing

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later published book. *See* Eddy Dow, Letter to the Editor, *The Rich Are Different,* N.Y. Times, Nov. 13, 1988, *available at* http://www.nytimes.com/1988/11/13/books/l-the-rich-are-different-907188. html.)

video games and game consoles. Hawkins left EA to run 3DO, which went public in 1993. Beginning in 1994, Hawkins sold large amounts of his EA stock to invest in 3DO. The capital gains from the sales were large: approximately $24 million in 1996, $3.8 million in 1997, and $39 million in 1998. His accountants, KPMG, advised him to shelter the gains in a Foreign Leveraged Investment Portfolio ("FLIP") and an Offshore Portfolio Investment Strategy ("OPIS"). Both strategies were designed to generate large paper losses to shield the EA capital gain from taxation.

To execute the FLIP transaction, Trip purchased shares of the Union Bank of Switzerland ("UBS") for $1.5 million and an option to acquire shares of Harbourtowne, Inc., a Cayman Islands corporation. Harbourtowne then contracted with UBS to purchase shares of UBS for $30 million, with UBS receiving an option to repurchase the shares before the sale closed. UBS exercised the option, and the UBS shares were never transferred to Harbourtowne. Hawkins then received a letter from KPMG stating that he could add to the tax basis of his UBS shares the $30 million that Harbourtowne had contracted to pay for its UBS shares. The opinion letter stated that UBS's repurchase of its shares would likely be considered a distribution to Harbourtowne (which was nontaxable because Harbourtowne was a foreign corporation), and that Harbourtowne's basis in its UBS shares should be treated as a transferred to Hawkins's basis in his UBS shares.

OPIS worked in a similar way. Hawkins purchased shares of UBS for $1.99 million and an option to acquire an interest in Hogue, Investors LP, a Cayman Islands limited partnership. Hogue contracted to purchase shares of UBS treasury stock, with UBS retaining a call option to repurchase the shares before transfer. UBS exercised the option. KPMG issued an opinion letter to Hawkins stating that he could add the Hogue shares to his basis in the UBS stock.

Over the next several years, Hawkins then sold various quantities of the UBS stock and claimed losses of approximately $6 million on his 1996 federal tax return, $23.4 million on his 1997 return, $20.5 million on his 1998 return, $3.5 million on his 1999 return, and $8.2 million on his 2000 return.

In 2001, the IRS challenged the validity of the tax shelters and commenced an audit of Hawkins's 1997 return, which later expanded to include the 1998-2000 tax years. In 2002, the IRS sent Hawkins's attorney a letter stating that the losses from the FLIP and OPIS transactions would be disallowed. The subsequent audit report indicated that Hawkins owed additional taxes and penalties of $16 million for tax years 1997-2000.

During this period, the financial fortunes of 3DO deteriorated to the point where it needed a large capital infusion. Hawkins loaned 3DO approximately $12 million, but it was to no avail. 3DO filed a voluntary petition in bankruptcy under Chapter 11 seeking

reorganization in 2003. It was later converted to a Chapter 7 liquidation, from which Hawkins never received a significant distribution.

Faced with these losses, Hawkins filed a motion in family court in 2003 to reduce the child support payments he was required to make to his first wife. He acknowledged that he owed $25 million to the IRS, had limited income, and was insolvent. The family court granted his request in part, but required him to place his assets in trust. During the family court proceedings, Hawkins's attorney testified that Hawkins intended to discharge the tax debt in bankruptcy proceedings.

In 2005, the IRS made an aggregate assessment of taxes, penalties, and interest for tax years 1997-2000 that totaled $21 million. The California Franchise Tax Board ("FTB") assessed $15.3 million in additional taxes, penalties, and interest for the same tax years. Hawkins made an offer in compromise to the IRS of $8 million, which was rejected.

The bankruptcy court found that Hawkins and his wife did very little to alter their lavish lifestyle after it became apparent in 2003 that they were insolvent and that their personal living expenses exceeded their earned income.

In July 2006, Hawkins sold his primary residence and paid the entire $6.5 million net proceeds to the IRS. A month later, the FTB seized $6 million from various financial accounts. In September of that year, the Hawkinses filed a Chapter 11 bankruptcy petition,

which the bankruptcy court found was for the primary purpose of dealing with their tax obligations. Shortly after filing, Hawkins sold the La Jolla condominium for $3.5 million and paid the proceeds to the IRS. Even after these payments and the seizure by the FTB, the IRS filed a proof of claim for $19 million and the FTB filed a claim for $10.4 million.

Hawkins proposed a liquidating plan of reorganization, which was confirmed by the bankruptcy court. The IRS received a distribution of $3.4 million from the estate. The confirmed plan discharged the Hawkinses from any debts that arose before the date of plan confirmation, but provided that the Hawkinses, IRS, or FTB could bring suit to determine whether the tax debts should be excepted from discharge. The Hawkinses filed this declaratory action against the IRS and FTB seeking a determination that the unpaid taxes were covered by the discharge. The IRS and FTB counterclaimed, alleging that the tax debts were excepted from discharge pursuant to 11 U.S.C. § 523(a)(1)(c), which excepts from discharge any debt "with respect to which the debtor . . . willfully attempted in any manner to evade or defeat such tax." The primary, but not exclusive, theory of the IRS and FTB was that the Hawkinses' maintenance of a rich lifestyle after their living expenses exceeded their income constituted a willful attempt to evade taxes. The bankruptcy court rejected most of the other government theories, but found that the Hawkinses' personal living expenses from January 2004 to September 2006 were "truly exceptional." The

court estimated that the couples' personal expenses exceeded their earned income by $516,000 to $2.35 million during that period. Given these facts, the bankruptcy court concluded that, as to Trip Hawkins, the tax debts were excepted from discharge. However, as to Lisa Hawkins, the court held that the tax debts were discharged. The district court affirmed. This timely appeal followed.

II

Generally, a debtor is permitted to discharge all debts that arose before the filing of his bankruptcy petition. 11 U.S.C. § 727(b). However, the Bankruptcy Code provides for certain exceptions to that general rule. 11 U.S.C. § 523. Relevant to our case, the Code provides that a debtor may not discharge any tax debts "with respect to which the debtor made a fraudulent return *or willfully attempted in any manner to evade or defeat such tax.*" 11 U.S.C. § 523(a)(1)(C) (emphasis added). As the district court correctly observed, our Circuit has not yet construed this provision, nor determined what mental state is required.

We begin by using the usual tools of statutory construction, the first step of which is to determine whether the language has a plain and unambiguous meaning with regard to the particular dispute. *Robinson v. Shell Oil Co.,* 519 U.S. 337, 340 (1997). In doing so, "we examine not only the specific provision at issue, but also the structure of the statute as a

whole, including its object and policy." *Children's Hosp. & Health Ctr. v. Belshe,* 188 F.3d 1090, 1096 (9th Cir. 1999). If the plain language is unambiguous, that meaning is controlling, and our inquiry is at an end. *Carson Harbor Vill., Ltd. v. Unocal Corp.,* 270 F.3d 863, 877-78 (9th Cir. 2001) (en banc). If the statutory language is ambiguous, then we consult legislative history. *United States v. Daas,* 198 F.3d 1167, 1174 (9th Cir. 1999). "We also look to similar provisions within the statute as a whole and the language of related or similar statutes to aid in interpretation." *United States v. LKAV,* 712 F.3d 436, 440 (9th Cir. 2013).

The key question in this case is the meaning of the word "willful" in the statute. Unfortunately, the plain words of the text do not answer that question because, as the Supreme Court has observed, "willful . . . is a word of many meanings, its construction often being influenced by its context." *Spies v. United States,* 317 U.S. 492, 497 (1943). Context matters in this case. The Bankruptcy Code is designed to provide a "fresh start" to the discharged debtor. *United States v. Sotelo,* 436 U.S. 268, 280 (1978). As a result, the Supreme Court has interpreted exceptions to the broad presumption of discharge narrowly. *See Kawaauhau v. Geiger,* 523 U.S. 57, 62 (1998). As we have observed "exceptions to discharge should be limited to dishonest debtors seeking to abuse the bankruptcy system in order to evade the consequences of their misconduct." *Sherman v. SEC* (*In re Sherman*), 658 F.3d 1009, 1015-16 (9th Cir. 2011), *abrogated on*

other grounds by Bullock v. BankChampaign, N.A., 133 S.Ct. 1754 (2013).

Thus, the "fresh start" philosophy of the Bankruptcy Code argues for a stricter interpretation of "willfully" than an expansive definition. Significantly, the Supreme Court recognized the Code's "fresh start" object and policy in construing the word "willfully" in considering a related discharge exception in *Kawaauhau.* In *Kawaauhau,* the creditors requested the Bankruptcy Court to hold a medical malpractice claim to be non-dischargeable under 11 U.S.C. § 523(a)(6), which provides that a "discharge [in bankruptcy] . . . does not discharge an individual debtor from any debt . . . for willful and malicious injury . . . to another." 523 U.S. at 59-61. The Supreme Court noted that, because the word "willful" modifies the word "injury" in § 523(a)(6), "a deliberate or intentional *injury,* not merely a deliberate or intentional *act* that leads to injury" was required to establish non-dischargeability. *Id.* at 61. The Supreme Court analogized "willful" as the mental state required for intentional torts, not for negligent acts. *Id.*

The structure of the statute also supports a narrow construction of "willfully." The discharge exception at issue, § 523(a)(1), lists tax and customs debts warranting exception in three categories. Under § 523(a)(1)(A), numerous types of debts are excepted from discharge on a strict liability basis. Under § 523(a)(1)(B), tax debts for which a return was not filed or was filed late may not be discharged. Section

523(a)(1)(C) is the grouping at issue here: no discharge is permitted for tax debts "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C). The grouping of the fraudulent return offense with the evasion offense in subsection (C) – rather than with the other offenses involving tax returns in subsection (B) – suggests that it is more akin to attempted tax evasion than to failing to file a timely return. If a willful attempt to evade taxation requires mere knowledge of the tax consequences of an act, and no bad purpose, then it is difficult to see how such acts resemble the filing of a fraudulent return. By contrast, if a willful attempt requires bad purpose, then such acts are naturally grouped with other acts requiring bad purpose, such as filing a fraudulently false return.

Not only does the structure of the statute as a whole, including its "object and policy," indicate that the term "willfully" is to be narrowly construed, but that interpretation is supported by legislative history. Section 523(a)(1) is described in the Congressional Record as a "compromise" between the House and Senate versions of a bill. 124 Cong. Rec. 32, 398 (1978). The House version contained the "willfully" language, H.R. Rep. No. 95-595, at 363 (1977), while the Senate version instead excepted tax debts for which the debtor "*fraudulently* attempted to evade" the tax, S. Rep. No. 95-989, at 78 (1978) (emphasis added). If the meaning of the Senate's language was so drastically reduced as to remove any bad purpose

from the exception for attempted tax evasion, it is surprising that such a change was not thought significant enough to warrant mention in the Congressional Record.

A narrow interpretation of "willfully" is also in accord with case precedent that generally except tax debts from discharge under § 523(a)(1)(C) only when the conduct amounting to attempted tax evasion is of a type likely to be accompanied by an evasive motivation. Acts found by other circuits to constitute "willful[ ] attempt[s]" include declining to file tax returns, shifting assets to another person or a false bank account, shielding assets, and switching all financial dealings to cash. *See, e.g., Vaughn v. Comm'r* (*In re Vaughn*), ___ F.3d ___, 2014 WL 4197347, at *6 n.5 (10th Cir. 2014) (purchase and transfer of a house to girlfriend; establishment and transfer of funds to a trust for a stepdaughter); *United States v. Coney,* 689 F.3d 365, 377 (5th Cir. 2012) (concealment of currency transactions); *In re Gardner,* 360 F.3d 551, 558 (6th Cir. 2004) (concealment of assets through special bank accounts); *United States v. Fretz* (*In re Fretz*), 244 F.3d 1323, 1329 (11th Cir. 2001) (failure to file tax returns); *Tudisco v. United States* (*In re Tudisco*), 183 F.3d 133, 137 (2d Cir. 1999) (failure to file returns); *United States v. Fegeley* (*In re Fegeley*), 118 F.3d 979, 984 (3d Cir. 1997) (failure to file returns); *In re Birkenstock,* 87 F.3d 947, 951-52 (7th Cir. 1996) (failure to file returns and attempt to conceal income); *Dalton v. IRS,* 77 F.3d 1297, 1302 (10th Cir. 1996) (concealment of asset ownership). With the exception

of the mere failure to file a return, these same acts satisfy the conduct requirement for criminal tax evasion in this Circuit. *See United States v. Carlson,* 235 F.3d 466, 468-69 (9th Cir. 2000).

A specific intent construction of "willfully" in the bankruptcy tax context is also supported by the Internal Revenue Code. In language almost identical to that used in § 523(a)(1)(C), the Internal Revenue Code makes it a felony to "willfully attempt[ ] in any manner to evade or defeat any tax." 26 U.S.C. § 7201. The specific intent required for felonious tax evasion "requires the Government to prove 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," *United States v. Bishop,* 291 F.3d 1100, 1106 (9th Cir. 2002) (internal quotation marks omitted); that is, a "voluntary, intentional violation of a known legal duty," *Cheek v. United States,* 498 U.S. 192, 201 (1991) (internal quotation marks omitted). *See also Edwards v. United States,* 375 F.2d 862, 867 (9th Cir. 1967) (interpreting the provision to require "willfulness in the sense of a specific intent to evade or defeat the tax or its payment"). The Supreme Court has clarified that such an attempt "almost invariably" 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." *Kawashima v. Holder,* 132 S.Ct. 1166, 1175, 1177 (2012). If attempted evasion under § 523(a)(1)(C) is interpreted in a similar manner, then it would require fraudulent, or at least specific, intent.

Similarly, in *Spies,* the Court considered the difference between the misdemeanor of willfully failing to pay a tax or file a timely return (§ 7203) with the felony of willfully attempting to evade or defeat a tax or its payment (present § 7201). 317 U.S. at 498. The Supreme Court rejected the government's contention, which is similar to the one it takes in this case, that a willful failure to file a return, coupled with a willful failure to pay the tax, constituted a willful attempt to evade or defeat a tax in violation of § 7201. *Id.* at 499. Rather, it interpreted the statute as requiring some "willful commission in addition to willful omissions." *Id.* It then provided some examples of qualifying acts, including keeping double books, making false bookkeeping entries, destruction of records, concealment of assets, along with "any kind of conduct, the likely effect of which would be to mislead or conceal." *Id.* Applying the logic of *Spies,* which was construing language almost identical to the phrase at issue, simply spending beyond one's income would not qualify as a "willful[ ] attempt[ ] in any manner to evade or defeat such tax."

Given the structure of the statute as a whole, including its object and policy, legislative history, case precedent, and analogous statutes, we conclude that declaring a tax debt non-dischargeable under 11 U.S.C. § 523(a)(1)(C) on the basis that the debtor "willfully attempted in any manner to evade or defeat such tax" requires a showing of specific intent to evade the tax. Therefore, a mere showing of spending in excess of income is not sufficient to establish the

required intent to evade tax; the government must establish that the debtor took the actions with the specific intent of evading taxes. Indeed, if simply living beyond one's means, or paying bills to other creditors prior to bankruptcy, were sufficient to establish a willful attempt to evade taxes, there would be few personal bankruptcies in which taxes would be dischargeable. Such a rule could create a large ripple effect throughout the bankruptcy system. As to discharge of debts, bankruptcy law must apply equally to the rich and poor alike, fulfilling the Constitution's requirement that Congress establish "uniform laws on the subject of bankruptcies throughout the United States." U.S. Const., art. I, § 8, cl. 4.

Some of our sister circuits have read 11 U.S.C. § 523(a)(1)(C) differently, interpreting the statute to require the government to show that the debtor "(1) had a duty to pay taxes under the law, (2) knew he had that duty, and (3) voluntarily and intentionally violated that duty." *Vaughn,* 2014 WL 4197347 at *6; *Coney,* 689 F.3d at 371; *Gardner,* 360 F.3d at 558; *Fretz,* 244 F.3d at 1330; *Fegeley,* 118 F.3d at 984; *Birkenstock,* 87 F.3d at 952; *Dalton,* 77 F.3d at 1300.

To the extent that these cases can be construed, as the government does, as holding that a tax debt can be considered dischargeable if the acts were committed intentionally, but not necessarily for the purpose of evading taxation, we respectfully disagree. However, most of the cases involve intentional acts or omissions designed to evade taxes, such as criminal

structuring of financial transactions to avoid currency reporting requirements (*Coney,* 689 F.3d at 369); concealing assets through nominee accounts (*Vaughn,* 2014 WL 4197347 at *6; *Gardner,* 360 F.3d at 559; *Birkenstock,* 87 F.3d at 952); concealing ownership in assets (*Vaughn,* 2014 WL 4197347 at *6; *Dalton,* 77 F.3d at 1302); and failing to file tax returns and pay taxes (*Fretz,* 244 F.3d at 1329; *Fegeley,* 118 F.3d at 984). These actions are not inconsistent with a specific intent requirement. And, although lavish lifestyle and ability to pay taxes have been mentioned by some Circuits, *see, e.g., Vaughn,* 2014 WL 4197347 at *6, no Circuit has held that living beyond one's means alone constitutes willful tax evasion, and no circuit has held that failure to pay taxes, by itself, constitutes willful tax evasion within the meaning of that clause in § 523(a)(1)(C).

III

Absent circuit law on this question, the district and bankruptcy courts held that specific intent to evade taxes was not required in order to except a tax debt from discharge under 11 U.S.C. § 523(a)(1)(C) and relied in large part on the Hawkinses' spending beyond their income as the basis for denying tax debt discharge. Aside from the KPMG transactions, most of the expenditures on which the government relies were made consistent with Hawkins's past spending practices, and investments were made in property that would be subject to tax liens. As far as the record discloses thus far, there were no financial transfers

into nominee accounts or concealment of assets, although the government claims that some funds ordered paid into trust by the family court were done so with the intent of tax evasion.

The government rightly points out that there were other facts that supported a finding of a willful failure to evade taxes that were cited as part of the decisions. However, given the heavy reliance on lifestyle choices in the decisions, it is not possible for us to determine if the district or bankruptcy court decisions would have been different without that consideration, and we decline to evaluate the other evidence tendered by the government in the first instance on appeal. Because neither the district court nor the bankruptcy court had the benefit of our conclusion that denial of discharge for "willfully attempt[ing] in any manner to evade or defeat" a tax debt requires that the acts be taken with the specific intent to evade the tax, we vacate the judgment and remand so that the courts can reanalyze the case using the specific intent standard. We need not, and do not, reach any other issue urged by the parties. Each party shall bear its or their own costs on appeal.

REVERSED AND REMANDED.

RAWLINSON, Circuit Judge, dissenting.

I respectfully dissent. I agree with the majority that the rich are different in many ways, but that difference should not include an unfettered ability to dodge taxes with impunity.

There is little doubt, if any, that William Hawkins deliberately decided to spend money extravagantly rather than pay his duly assessed state and federal taxes. Hawkins now seeks to discharge these taxes in bankruptcy.

The Bankruptcy Code precludes discharge of tax debts "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C). We must now decide whether Hawkins' actions avoiding payment of the taxes was "willful." I disagree with the majority on this point.

The proceedings before the bankruptcy court are telling. There is no question that Hawkins was aware of the substantial sums he owed in taxes as early as 2004. *See Bankruptcy Court Memorandum Decision,* p. 7 (noting that during family court proceedings to reduce child support payments, Hawkins acknowledged owing $25 million in taxes). Even after acknowledging the tax debt, Hawkins maintained a home worth well over $3.5 million, and an ocean-view condominium worth well over $2.6 million. *See id.,* pp. 9-10. Although there were only two drivers in the family, Hawkins purchased a fourth vehicle that cost $70,000.00. *See id.,* p. 10. At the family court hearing, Hawkins' bankruptcy attorney "testified that Hawkins' *intent was not to pay the tax debt,* but to discharge it in bankruptcy. . . ." *Id.,* p. 19. This testimony is a strong indication of a willful intent to avoid the payment of taxes by hook or by crook. Indeed, the bankruptcy court noted that the personal living

expenses of the Hawkins family during the period in question were "truly exceptional." *Id.,* p. 20. Incredibly, the family "spent between $16,750 and $78,000 more" each month than their income. *Id.* The bankruptcy court determined that the wasting of assets through profligate spending indicated willful evasion of tax payments. *See id.,* p. 27. Ultimately, the bankruptcy court relied upon the following "badges of evasion": 1) Hawkins' "exceptional business sophistication"; 2) his "open acknowledgment of his tax debt and insolvency"; 3) the lengthy period of wasteful spending; 4) the amount of wasteful spending; and 5) "the extent to which the wasteful expenditures exceeded . . . earned income." *Id.,* p. 29.

The majority opinion gives Hawkins a pass by focusing on the Bankruptcy Code's purpose of providing a "fresh start" to debtors. However, this overly expansive interpretation of the "fresh start" policy could easily eclipse all discharge exceptions. The majority's conclusion, in my view, creates a circuit split and turns a blind eye to the shenanigans of the rich.

I am persuaded by the reasoning of a recent decision in the Tenth Circuit involving similar circumstances, *Vaughn v. IRS* (*In re Vaughn*), No. 13-1189, 2014 WL 4197347 (10th Cir. Aug. 26, 2014). In that case, the Tenth Circuit cited to the district court decision in this case to support its ruling. *See id.* at *6 (citing *Hawkins v. Franchise Tax Bd.,* 447 B.R. 291, 300 (N.D. Cal. 2011)). In *Vaughn,* as in *Hawkins,* a

wealthy taxpayer sought to discharge through bankruptcy a substantial amount of taxes owed. *See id.* at *4.

The Tenth Circuit held that the determination of "whether or not a debtor willfully attempted to evade or defeat a tax under 11 U.S.C. § 523(a)(1)(C) is a question of fact reviewable for clear error. . . ." (citation, footnote, reference and alterations omitted). *Id.* at *6. The court articulated the following elements required to satisfy the mental state requirement: "1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty." *Id.* (citing *Vaughn v. IRS* (*In re Vaughn*), 463 B.R. 531, 546 (Bankr. D. Colo. 2011); *Hawkins,* 447 B.R. at 300).

The Tenth Circuit incorporated a number of findings from the bankruptcy court to support the conclusion that Vaughn acted willfully to evade taxes, including failure to preserve assets despite knowledge of substantial tax liability, and "numerous large expenditures." *Id.* n.5.[1] The Tenth Circuit also adopted the observation made in *Hawkins* that "nonpayment of a tax can satisfy the conduct requirement when paired with even a single additional culpable act or omission." *Id.* (quoting *Hawkins,* 447 B.R. at 301).

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[1] Notably, these same findings also were made by the bankruptcy court in this case.

I would follow the lead of the Tenth Circuit and affirm the bankruptcy court ruling denying discharge of Hawkins' substantial tax liability due to his willful attempt to avoid payment of those taxes through profligate spending. The bankruptcy court's findings were not clearly erroneous and were consistent with the persuasive rationale articulated by the Tenth Circuit in *Vaughn*. Providing a fresh start under the Bankruptcy Code should not extend to aiding and abetting wealthy tax dodgers. I respectfully dissent.