

**In The  
Supreme Court of the United States**

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JAMES CHARLES VAUGHN,

*Petitioner,*

v.

UNITED STATES OF AMERICA,  
INTERNAL REVENUE SERVICE,

*Respondent.*

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

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**REPLY BRIEF IN SUPPORT OF  
PETITION FOR WRIT OF CERTIORARI**

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## TABLE OF CONTENTS

	Page
I. SUMMARY .....	1
II. RESPONSE TO GOVERNMENT'S COUNTER-STATEMENT OF THE CASE .....	2
III. ARGUMENT .....	4
A. The majority of circuits are wrong, and in disarray .....	4
B. The Ninth Circuit is the only circuit to interpret section 523(a)(1)(C) properly.....	10
IV. CONCLUSION .....	12

## TABLE OF AUTHORITIES

## Page

## CASES

<i>American Boat Co., LLC v. United States</i> , 583 F.3d 471 (7th Cir. 2009).....	3, 8
<i>Blum v. Commissioner</i> , 737 F.3d 1303 (10th Cir. 2013).....	3
<i>Global-Tech Appliances, Inc. v. SEB S.A.</i> , 131 S.Ct. 2060 (2011).....	8, 12
<i>Hawkins v. The Franchise Tax Board of California</i> , 769 F.3d 662 (9th Cir. 2014).....	10, 11
<i>In re Birkenstock</i> , 87 F.3d 947 (7th Cir. 1996) .....	6
<i>In re Fegeley</i> , 118 F.3d 979 (3d Cir. 1997) .....	5
<i>In re Fretz</i> , 244 F.3d 1323 (11th Cir. 2001) .....	7, 10
<i>In re Gardner</i> , 360 F.3d 551 (6th Cir. 2004).....	5
<i>In re Haas</i> , 48 F.3d 1153 (11th Cir. 1995).....	6, 7
<i>In re Jacobs</i> , 490 F.3d 913 (11th Cir. 2007) .....	5
<i>In re Toti</i> , 24 F.3d 806 (6th Cir. 1994).....	6, 7
<i>Kawaauhau v. Geiger</i> , 523 U.S. 57 (1998).....	11, 12
<i>Klamath Strategic Inv. Fund, LLC v. United States</i> , 472 F.Supp.2d 885 (E.D. Tex. 2007), <i>aff'd</i> , 568 F.3d 537 (5th Cir. 2009).....	3
<i>Mallo v. United States</i> , No. 14-1072 .....	6
<i>Safeco Insurance Company of America v. Burr</i> , 551 U.S. 47 (2007).....	9
<i>Spies v. United States</i> , 317 U.S. 492 (1943) ...	9, 10, 12

## TABLE OF AUTHORITIES – Continued

	Page
<i>United States v. Boyle</i> , 469 U.S. 241 (1985) .....	3, 4, 8
<i>United States v. Coney</i> , 689 F.3d 365 (5th Cir. 2012) .....	5
<i>United States v. Pomponio</i> , 429 U.S. 10 (1976) .....	4
<i>United States v. Stanley</i> , 595 Fed.Appx. 314, 2014 WL 6997518 (5th Cir.) .....	6
<i>United States v. Storey</i> , 640 F.3d 739 (6th Cir. 2011) .....	7, 8

## STATUTES

11 U.S.C. § 523(a)(1) .....	6
11 U.S.C. § 523(a)(1)(B) .....	6
11 U.S.C. § 523(a)(1)(C) .....	<i>passim</i>
26 U.S.C. § 6020 .....	6
26 U.S.C. § 7201 .....	1, 4, 5, 9, 10
26 U.S.C. § 7203 .....	1, 4, 5, 10
26 U.S.C. § 7601 .....	4

## OTHER AUTHORITIES

Model Penal Code § 2.02 .....	8, 11
Model Penal Code § 2.02(5) .....	12

## I. SUMMARY

The government acknowledges that there is an actual circuit split between the Ninth Circuit and all other circuits. Opp. 14-17. The government tries to downplay the split, but ultimately endorses the majority approach for determining willfulness as the voluntary and intentional violation of a known duty to pay taxes. The government further argues that Vaughn sides with the majority against the Ninth Circuit's new specific intent requirement. Opp. 11, 15.

This is backwards. Vaughn has shown that the majority approach of finding willful evasion or defeat based on failure to pay taxes or failure to file a return is erroneous, and has led to confusion and arbitrary decisions in the circuits. The Ninth Circuit's specific intent requirement is the only approach that comports with the statutory language of 11 U.S.C. § 523(a)(1)(C) and 26 U.S.C. §§ 7201 and 7203 (which the government does not address), and this Court's teachings that "willfulness" is more than negligence – it is comparable to the level of "knowingly" on the Model Penal Code's hierarchy of mental culpability states. The Ninth Circuit thus has the rare and remarkable distinction of being the only circuit to interpret the law correctly in this split.

Vaughn's case presents the perfect vehicle for addressing this split because his facts – spending in light of a potential but uncertain future tax obligation – elucidate the mental state requirement that the circuits have split upon. In an evasion case involving,

*e.g.*, double sets of books, willful intent to evade is obvious from the evasive conduct. But lavish living cases are about *defeating* a tax through spending. Vaughn spent money on himself and his family when he knew he might be assessed a tax in the future. Vaughn's culpability depends on how likely an assessment was, and how his spending decisions impacted his remaining assets that might be used to pay a potential future tax bill. The details and timing of these spending decisions (and Vaughn's loss of assets in his divorces) were well developed below, are not disputed, and support Vaughn's position. The only issue is how the lower courts selectively viewed those facts to support their decision to deny Vaughn a discharge under an erroneous legal standard. Vaughn's facts and the lower courts' erroneous rulings here thus provide an excellent backdrop to clarify what it means to willfully defeat a tax.

The Court should take certiorari to settle the split and confused standards for denying a debtor a discharge for willfully evading or defeating a tax, restore uniformity, and remand for application of the correct standard here.

## **II. RESPONSE TO GOVERNMENT'S COUNTER-STATEMENT OF THE CASE**

Government's statement of the case mirrors Vaughn's. The government acknowledges that Vaughn participated in a tax shelter that KPMG opined was

“more likely than not” to survive an audit, Opp. 2-3; but the government ignores how other courts have ruled that such reliance on a top-tier tax advisory firm like KPMG is reasonable, or at worst negligent. *American Boat Co., LLC v. United States*, 583 F.3d 471, 481 (7th Cir. 2009) (reasonable); *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F.Supp.2d 885, 904-05 (E.D. Tex. 2007), *aff’d*, 568 F.3d 537 (5th Cir. 2009); *Blum v. Commissioner*, 737 F.3d 1303, 1317-18 (10th Cir. 2013) (negligent); *see generally 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*).

The government’s recitation of facts also notes how Vaughn was divorced twice in quick succession, both before he was audited and assessed by the IRS. Opp. 4-5. But the government avoids how these divorces reduced Vaughn’s assets, no doubt because the lower courts chose to ignore this critical aspect of the analysis in their opinions. Yet the details of Vaughn’s divorces, including their timing in relation to the tax assessment and their impact on his assets, were well developed below and have always figured prominently in Vaughn’s arguments.

The government’s brief also highlights the bankruptcy court’s erroneous fraudulent return determination. Opp. 6. The district court implicitly recognized that a finding of fraud could not be sustained where a top-tier tax firm advises a taxpayer that a deduction

is legitimate. App. 29-30 and n.5; *accord Boyle*, 469 U.S. at 251. The Tenth Circuit did not revive the implicitly rejected fraud finding, as it could have under the affirm-on-any-basis rule. As a result, the lower courts based their denial of Vaughn’s presumptive right to discharge his tax debt solely and squarely on the finding that he willfully attempted to evade or defeat a tax that had not yet been assessed, and that he had been advised would probably not be assessed, through his pre-assessment spending.

### III. ARGUMENT

#### A. The majority of circuits are wrong, and in disarray.

Vaughn’s petition demonstrates that willfully evading or defeating a tax must mean something more than not paying one’s taxes or not filing returns. Failure to pay or file constitutes a misdemeanor, not the felony crime of tax evasion with identical language to section 523(a)(1)(C). *Compare* 26 U.S.C. §§ 7203 and 7201. The government offers no response to this analysis.

The government instead endorses the culpability standard applied by the majority of circuits: voluntary and intentional violation of a known “duty.” Opp. 14.<sup>1</sup> This vague “duty” formula breaks down when

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<sup>1</sup> This formulation comes from *United States v. Pomponio*, 429 U.S. 10, 12 (1976), which addressed the *mens rea* requirement for a criminal conviction under 26 U.S.C. § 7601, for filing

(Continued on following page)

applied to defeating a tax. Some circuits (like the Tenth Circuit here) leave the duty undefined. App. 15; *In re Jacobs*, 490 F.3d 913, 921 (11th Cir. 2007). If the duty is to not evade or defeat one's tax obligations, then the standard is circular and meaningless.

Other circuits describe the duty as a duty to pay taxes or to file returns. *E.g.*, *United States v. Coney*, 689 F.3d 365, 374 (5th Cir. 2012) (duty to pay taxes); *In re Gardner*, 360 F.3d 551, 558 (6th Cir. 2004) (same); *In re Fegeley*, 118 F.3d 979, 984 (3d Cir. 1997) (duty to file returns). The government endorses those cases holding that voluntarily and intentionally violating the duty to *pay taxes* deprives a debtor of his presumptive right to a discharge. Opp. 14.

This position is plainly wrong. If a taxpayer files a return and then instead of writing a check to the Treasury tells the IRS to come get it, that taxpayer does nothing to evade or defeat a tax; he just makes the government work harder to collect. This taxpayer has committed the misdemeanor crime of intentional nonpayment of a tax, not the more serious felony of evasion or defeat of a tax. 26 U.S.C. §§ 7203, 7201. Only the latter conduct suffices to deny a debtor a bankruptcy discharge under the identically-worded section 523(a)(1)(C). Likewise, if the taxpayer fails to

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a false return, not for willful evasion under section 7201. As discussed, Vaughn's return was not false or fraudulent – he disclosed all his income, and took a deduction that was endorsed as legitimate by KPMG. Everything was there for the IRS to review.

file a return, he does not evade or defeat his tax obligations, but again makes the government work harder: this time by calculating his tax obligation for him, and then collecting it. *See* 26 U.S.C. § 6020.<sup>2</sup> This is also the misdemeanor, not the felony of willful evasion or defeat.

Applying the voluntary-and-intentional-violation-of-a-known-duty formula, the circuits have inconsistently held that failure to pay taxes or file returns may or may not constitute willful evasion or defeat of a tax under section 523(a)(1)(C). *Compare, e.g., United States v. Stanley*, 595 Fed.Appx. 314, 2014 WL 6997518, \*4 (5th Cir.) (“a knowing and deliberate nonpayment provides the basis for determining that the tax debt is non-dischargeable”)<sup>3</sup> *with In re Haas*, 48 F.3d 1153, 1155 (11th Cir. 1995) (“debtor’s failure to pay his taxes, without more” does not constitute a willful attempt to evade or defeat a tax); and *In re Birkenstock*, 87 F.3d 947, 951 (7th Cir. 1996) (“non-payment of tax alone is not sufficient to bar discharge of a tax liability”). The Sixth Circuit appears to go both ways. *Compare In re Toti*, 24 F.3d 806, 809 (6th Cir. 1994) (“[F]ailure to file a tax return and failure to

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<sup>2</sup> The pending certiorari petition in *Mallo v. United States*, No. 14-1072, addresses the issues of non-filed or late-filed returns, how the IRS computes tax owed absent a return, and their impact on discharge under adjacent subsection 523(a)(1)(B) of the Bankruptcy Code. The Court may wish to consider this petition together with *Mallo* so as to better construe section 523(a)(1).

<sup>3</sup> Petition for certiorari pending, No. 14-1179.

pay a tax fall within the definition in § 523(a)(1)(C) of a willful attempt to evade or defeat a tax liability”) *with United States v. Storey*, 640 F.3d 739, 744-45 and n.2 (6th Cir. 2011) (discussing differing rulings among the Sixth and other circuits, and ultimately rejecting IRS’s argument for willful evasion based on nonpayment alone). And while the Eleventh Circuit will not deny a debtor a discharge for failing to pay taxes, *Hass, supra*; it will deny discharge to debtors who also fail to file returns. *In re Fretz*, 244 F.3d 1323, 1324 (11th Cir. 2001).

While some of these cases may have facts that can support evasion or defeat of a tax, the legal standard that the cases employ, and which is endorsed by the government here, is demonstrably wrong. Some debtors who are entitled to a discharge get one, *see Storey, supra*; but other qualified debtors do not. *See Fretz*, 244 F.3d at 1331 (denying discharge to debtor for ignoring his tax obligations); *Toti*, 24 F.3d at 809 (same). The vague, subjective and erroneous majority standard has thus resulted in widely inconsistent rulings in this area of bankruptcy law, where the Constitution requires consistency.

Vaughn’s case elucidates the culpability requirement of section 523(a)(1)(C) better than any of these erroneously decided circuit cases. Vaughn timely filed tax returns which disclosed all his income and deductions. He knew there was some probability that the IRS might deny the BLIPS deduction, but KPMG had assured him that this probability was under 50%. Did Vaughn willfully defeat a tax by spending some of

his money on himself and his family while knowing there was an unlikely possibility of a future tax assessment? Until Vaughn was assessed a tax, he had no duty to pay it. And after he was cleaned out by his second divorce (before he was assessed), he had insufficient money to pay it, making his nonpayment involuntary. The most that can be said was that Vaughn should have foreseen the future assessment, and saved his money to cover it instead of spending it on himself and his family. That is why the bankruptcy court's decision is permeated with the language of negligence – it wrongly denied Vaughn a discharge for spending money on himself and his family when he “should have known” to save it to cover his potential future tax obligation. App. 56, 59, 62, 66.

But to be *willful*, Vaughn's spending decisions must have been at least “practically certain” to result in an inability to pay a potential future tax obligation. Model Penal Code § 2.02; *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S.Ct. 2060, 2069-71 (2011) (equating willfulness with the Model Penal Code culpability level of knowingly). There is simply no other way to square section 523(a)(1)(C)'s culpability requirement with the law permitting reliance on the advice of tax professionals such as KPMG, *e.g.*, *Boyle*, 469 U.S. at 251; *American Boat Co.*, 583 F.3d at 481; and the possibility of losing one's assets through non-culpable financial catastrophe. *E.g.*, *Storey*, 640 F.3d at 745 (rejecting IRS's position because when debtor spent money on a home, “there was no evidence

that she was even aware she would later become unable to pay her taxes.”).

Under the vague majority formulation, any taxpayer who takes a deduction, spends money, becomes insolvent, and is then audited and assessed a tax, may be deemed to have willfully defeated his tax obligation. It all depends on how judges feel about the taxpayer’s deduction and spending. To preserve their right to a bankruptcy discharge (and indeed to avoid potential criminal liability), taxpayers would have to escrow funds to cover every deduction they take, lest a deduction be denied in an audit years later when the taxpayer no longer has sufficient assets to cover the resulting assessment. Given the vague and erroneous violation-of-a-duty-to-pay-taxes standard, a taxpayer could be prosecuted or denied a discharge for *any* deduction or spending that a judge, in hindsight, later frowns upon.

The government asserts that in this civil context, a lower culpability level should apply. Opp. 17, citing *Safeco Insurance Company of America v. Burr*, 551 U.S. 47, 56-58 (2007) (describing willful as a “word of many meanings,” and employing a culpability level of recklessness for violations of the Fair Credit Reporting Act). But for bankruptcy discharges under section 523(a)(1)(C), the meaning of willful is provided by *Spies v. United States*, 317 U.S. 492 (1943), which interpreted the identical language of 26 U.S.C. § 7201. While *Spies* focuses on willful evasion rather than defeat of a tax, it unquestionably applies a culpability requirement of at least knowingly. 317 U.S. at 498

(willfulness includes “some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer.”).

**B. The Ninth Circuit is the only circuit to interpret section 523(a)(1)(C) properly.**

The government tries to downplay the circuit split caused by the Ninth Circuit’s application of a specific intent standard in *Hawkins v. The Franchise Tax Board of California*, 769 F.3d 662 (9th Cir. 2014), but the government ultimately acknowledges the split and asserts that *Hawkins* was wrongly decided. Opp. 17.

*Hawkins*, however, is the only circuit decision to properly analyze what it means to willfully defeat a tax obligation by spending one’s money on other things. Unlike other circuit cases, *Hawkins* considered the difference between failing to pay or file returns, and willful evasion or defeat of a tax. 769 F.3d at 668, contrasting 26 U.S.C. §§ 7201 and 7203 in accordance with *Spies*, 317 U.S. at 498. *Hawkins* also stands apart in applying this Court’s directive in *Spies* to consider all the financial circumstances of the taxpayer. *Id.*; compare, e.g., *Fretz*, 244 F.3d at 1327 (selectively quoting *Spies*, and ignoring directive to consider all financial circumstances); Opp. 5 and App. 9 (noting Vaughn’s 2003 divorce from St. Onge and resulting loss of assets, but ignoring how that loss impacted his ability to pay the 2004 tax assessment). Of all the circuit cases, only *Hawkins* properly

considers how nearly all debtors end up in bankruptcy not because of an intentional desire to short-change their creditors, but through commonplace profligacy – *i.e.*, through financial catastrophe or mismanagement that may entail no more than ordinary negligence. 769 F.3d at 669 (“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.”) And *Hawkins* correctly holds that liabilities based on negligent conduct are dischargeable. *Id.* at 666, citing *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998). Denial of a discharge must require conduct that is more culpable than ordinary negligence.

Thus, while the Ninth Circuit’s analysis in *Hawkins* puts it at odds with all other circuits, it is the Ninth Circuit that is interpreting that language of section 523(a)(1)(C) and this Court’s precedents correctly.

The only aspect of *Hawkins* that might be questioned is its adoption of the highest possible culpability state: specific intent. When debtors spend beyond their means, they generally are spending for their own purposes and not for the specific purpose of preventing creditors like the IRS from collecting debts. This is why Vaughn suggests that a more apt culpability level would be “knowingly” – *i.e.*, an awareness that one’s spending is “practically certain” to result in reducing assets available for the IRS to collect. Model Penal Code § 2.02. This comports with

the Court's equation of willfulness with this Model Penal Code culpability level. *Global-Tech Appliances, supra*.

But as the circuit split stands, the Ninth Circuit is still the only circuit to correctly interpret the culpability requirement of section 523(a)(1)(C), since specific intent (*i.e.*, “purposely”) satisfies the next-lower level of “knowingly.” See Model Penal Code § 2.02(5). All the other circuits’ standard of allowing willful evasion or defeat to be found based on failure to pay taxes or file returns permits the negligence of ordinary profligacy to be treated as willful, contrary to this Court’s teachings in *Spies* and *Kawaauhau*. The discharge of a tax debt in bankruptcy thus becomes an unguided, *ad hoc* dispensation of judicial mercy – some debtors are granted absolution, while others are arbitrarily denied despite presenting facts that clearly do not meet the legal requirements for a section 523(a)(1)(C) denial of discharge.

#### IV. CONCLUSION

The government acknowledges that the circuits are split. The majority approach is demonstrably wrong, and vague. It provides no clear standard at all for determining the debtor’s culpability and entitlement to a discharge. The Ninth Circuit stands alone in adopting a correct analysis of the statutory language and this Court’s precedents, but it arguably overshoots the mark by imposing a specific intent requirement where “knowingly” might suffice.

The well-established and clear facts of this case present the perfect vehicle for elucidating the problems with both sides of the circuit split, and for providing a proper interpretation of section 523(a)(1)(C)'s culpability requirement.

This Court should take 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.

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