POINTS TO **REMEMBER**

Editor's Note: The three POINTS TO **REMEMBER** in this issue cover three very different areas. First, Steve Johnson examines whether an individual can be prosecuted for the crime of failure to pay when the reason for the failure is financial inability to do so. Next, Dianne Bennett tells us about the Service's new audit initiative on executive compensation and discusses some of its possible implications. Finally, Monte Jackel and Glenn Mincey explain the proposed regulations on how sections 704(c) and 737 apply to installment obligations and contributed contracts. All three Points contribute to our understanding of important areas of the tax law.

THE **FINANCIAL INABILITY DEFENSE** TO TAX CRIMES

by Steve R. Johnson, Las Vegas, NV

Your client files an income tax return correctly stating her tax liability, but she does not pay the reported liability. Usually, this is a civil matter, implicating the failure-to-pay penalty of section 6651(a)(2). In aggravated circumstances, it can become criminal under either section 7201 or section 7203.

Section 7201 felony charges based on failure to pay are relatively rare but do occur. Section 7203 misdemeanor cases are more frequent. Many elements are common to the two sections. For instance, they share the same scienter requirement: willfulness, the "voluntary, intentional violation of a known legal duty." *United States v. Bishop,* 412 U.S. 346, 360 (1973).

The key difference is that the section 7201 offense requires that there have been an "attempt" to evade tax—some "commission" or "affirmative action" by the defendant–taxpayer. Willful failure to pay, without more, violates section 7203, but section 7201 is violated only when willful failure to pay is accompanied by some affirmative act. *Spies v. United States,* 317 U.S. 492, 498–99 (1943). Affirmative acts include keeping a double set of books, making false entries, destroying records, concealing assets or sources of income, "and any conduct, the likely effect of which would be to mislead or conceal." *Id.* at 495.

Can your client escape prosecution under sections 7201 and 7203 if she lacked the wherewithal to pay the reported tax liability? Specifically, does financial inability negate the willfulness element? The courts are split although some of the differences may be more apparent than real.

THE THREE (?) VIEWS

The Supreme Court seemed to endorse financial inability as a viable argument in the seminal *Spies* case. The Court adverted to "want of justification in view of all the financial circumstances of the taxpayer" as an element of willfulness. 317 U.S. at 498. Subsequent lower court decisions, though, have fallen into three categories.

The first category consists of cases where courts clearly endorsed the argument and put the burden of proof as to it on the Government. As one circuit court held: "To establish the offense of a wilful failure to pay the taxes assessed, the Government was required to prove that the financial circumstances of the taxpayer were such that . . . the taxpayer possessed sufficient funds to be able to meet his legal obligation to the Government." *United States v. Andros,* 484 F.2d 531, 533–34 (9th Cir. 1973).

A second category consists of cases where courts appear to reject the proposition that financial inability can be exculpatory. One circuit court saw the argument as "border[ing] on the ridiculous." Why? "As a general rule, financial ability to pay the tax when it comes due is not a prerequisite to criminal liability under [section] 7203. Otherwise, a recalcitrant taxpayer could simply dissipate his liquid assets at or near the time when his taxes come due and thereby evade criminal liability." *United States v. Tucker,* 686 F.2d 230, 233 (5th Cir), *cert. denied,* 459 U.S. 1071 (1982); see also *United States v. Ausmus,* 774 F.2d 722, 724–25 (6th Cir. 1985).

While the foregoing sounds categorical, it probably isn't. The *Tucker* court qualified its formulation with "[a]s a general rule." Moreover, the rule propounded must be understood in its factual context. Both the *Tucker* and *Ausmus* defendants engaged in lavish consumption. *See* 774 F.2d at 723; 686 F.2d at 232. The better reading of those cases probably is (1) financial inability is irrelevant when the defendant–taxpayer has dissipated his assets, not (2) financial inability always is irrelevant because of the possibility that defendant–taxpayers may dissipate their assets.

Reading those cases to mean that financial inability is irrelevant when the defendant has dissipated his assets would bring the second category of cases in line with the third. Courts in this third category expressly provide that the Government successfully shoulders its burden of proof only if it shows either (1) that the defendant–taxpayer had enough funds to allow him to pay the tax liability or (2) that the defendant–taxpayer lacked such funds but that inability was the product of his voluntary and intentional actions which are unjustified in view of the totality of his circumstances. E.g., *United States v. Evangelista,* 122 F.3d 112, 119 (2d Cir. 1997), *cert. denied,* 522 U.S. 1114 (1998); *United States v. Williams,* 121 F.3d 615, 621 (11th Cir. 1997), *cert. denied,* 523 U.S. 1065 (1998).

PARTIAL INABILITY

Taxpayers who cannot pay the Service often cannot pay other creditors and claimants as well. What if the defendant–taxpayer has some assets

but not enough to pay all claims of all creditors? Is she compelled to pay the Service first on pain of imperiling an otherwise good financial inability defense? (I use defense in a non-technical sense. In the view of at least some courts, financial ability is an element of the case the Government must establish, not an affirmative defense to be offered by the defendant–taxpayer after the Government has put on a prima facie case.)

Once again, the courts are or appear to be divided. *United States v. Goodman,* 190 F. Supp. 847 (N.D. Ill. 1961), is an example of a strong pro-defendant case. The defendant–taxpayer was a lawyer who had unpaid income taxes for 10 straight years. The court held that the evidence did not support conviction under section 7203. It concluded that various acts did "not indicate a consistent program of divestment of assets and attachable income with a purpose of defeating tax collection. For the most part these circumstances reflect the defendant's financial insolvency." *Id.* at 857. The Government had complained that the defendant had used borrowed money to pay other creditors in preference to the Government. The court firmly rejected this argument. It said: "I think it obvious that there is no requirement that a person must borrow money or agree to an assignment of his fees in order to pay his income tax liabilities, nor is there any requirement that a person prefer the government as a creditor." *Id.* at 856.

The court in *United States v. Lewis,* 671 F.2d 1025 (7th Cir. 1982), took a different approach. The trial court had refused to give an "insufficient money to pay" instruction to the jury in a section 7203 case. The appellate court affirmed on the ground that a "judge is obligated to instruct the jury only on a defense theory that has 'some foundation in the evidence' . . . . That foundation was not laid." 671 F.2d 1025, 1028. Courts that view financial ability as among the elements the Government must prove would frown on *Lewis*.

ANALOGIES

The preponderance of the authorities teach that financial inability is exculpatory as to section 7201 and section 7203 charges, and some apparently contrary cases may be explicable on their facts. In my view, the courts are correct in considering ability to pay. Two related areas of the law support that view.

First, willful failure to pay child support is a crime under the Child Support Recovery Act, 18 U.S.C. section 228. According to the legislative history, "willfulness" for this purpose was "borrowed from the tax statutes that make willful failure to collect or pay taxes a Federal crime," and willfulness should be interpreted in the same fashion for the two sets of laws. H.R. Rep. No. 102–771, at 6 (1992). The legislative report cites with approval one of the cases holding that establishing financial ability is part of the Government's burden of proof. *Id.* (citing *United States v. Poll,* 521 F.2d 329, 333 (9th Cir. 1975)).

Post-enactment indicators of congressional intent—and the above legislative report post-dates enactment of sections 7201 and 7203—are weak tools of statutory interpretation, of course. Nonetheless, courts often have looked to them. *See* Steve R. Johnson, *The Canon that Tax Penalties Should Be Strictly Construed*, 3 NEVADA LAW JOUR. 495, 508 (2003).

Second, financial inability is a recognized defense against the civil failure-to-pay penalty of section 6651(a)(2). *See* Treas. Reg. § 301.6651–1(c)(1). The regulation puts the burden of proving reasonable inability on the taxpayer. However, the regulation preceded and has not been updated to reflect the enactment in 1998 of section 7491(c), which imposes the burden of production on the Service as to penalties. *See generally* Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Tax Burden-of-Proof Rules*, 84 IOWA LAW REV. 413, 425–427 (1999). That financial inability is a defense against a civil penalty suggests that it also should be a defense against criminal sanctions.

POINTS TO REMEMBER

There are differences among the circuits (sometimes real, sometimes apparent) as to whether and when financial inability to pay the reported tax exonerates the defendant–taxpayer from punishment under sections 7201 or 7203. That being so, the attorney must carefully research and assess the law of the relevant circuit in each case.

The issue may arise (1) in pre-indictment discussions with the Government, (2) during trial, incident to a motion to dismiss or to propounding proposed jury instructions, or (3) on appeal. Typically, the earlier the issue is raised, the better. Thus, the attorney should perform the research and assessment at the earliest feasible time after being retained.

NEW PRESSURES ON **EXECUTIVE COMPENSATION**

by Dianne Bennett, Buffalo, NY

Executive compensation is under attack from a variety of sources, including the Service's pilot comprehensive audit project, which could result in more taxes for both companies and executives. Although any one company's chances of being part of the initial audit project are small, the type of initiative, the manner in which it was announced, and the eight areas it targets all provide guidance for attorneys advising clients in this area.

The Service's new audit program initially focuses on only a dozen large companies. It appears that these dozen already have received the first requests for information, so they know who they are, but, as can be expected, they aren't exactly talking. Launching the initiative is the Service's Large and Mid-Size Business Division (LMSB), which covers about 200,000 companies—any entity with more than $10 million in assets. It is reasonable to assume that the dozen are among the very largest companies, primarily public companies