

Supreme Court, U.S.
FILED

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No.

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

*On Petition for a Writ of Certiorari to the United States
Court of Appeals for the Ninth Circuit*

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. What effect must a federal court give a final, non-collusive state court judgment adjudicating ownership of property in determining a taxpayer's federal income tax liability arising from that property?

2. Whether a taxpayer who seeks to invoke the return of capital rule in a criminal tax case must show a contemporaneous intent to treat the corporate distribution as a return of capital?

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PETITION FOR A WRIT OF CERTIORARI

Michael Boulware petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1-14) is reported at 470 F.3d 931. The court of appeals' order denying Boulware's petition for rehearing (App. 63) is unreported. The district court's jury instructions and oral rulings (App. 15-26) are unreported. The court of appeals' ruling on Boulware's first appeal (App. 27-62) is reported at 384 F.3d 794.

JURISDICTION

The court of appeals entered judgment on December 13, 2006. App. 1. The court denied a timely petition for rehearing on April 23, 2007. App. 63. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 301 of Title 26, United States Code, provides in relevant part:

- (a) In general. Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

.....
(c) Amount taxable. In the case of a distribution to which subsection (a) applies--

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general. . . . [T]hat portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

.....
Section 316 of Title 26, United States Code, provides in relevant part:

(a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders--

(1) out of its earnings and profits accumulated after February 28, 1913

.....

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

STATEMENT OF THE CASE

Petitioner Michael Boulware founded Hawaiian Isles Enterprises ("HIE") in the 1980s and served as chairman and president of the company. HIE and its subsidiaries sell coffee, bottled water, and other products. At all relevant times, Boulware owned a substantial portion of the HIE stock.

Over a period of years beginning in 1987, Boulware transferred approximately \$4.5 million from HIE to his girlfriend, Jin Sook Lee. In 1994, Lee sued Boulware and HIE in Hawaii state court, claiming that they had improperly obtained money and property from her. Boulware and HIE counterclaimed, seeking a declaration that Lee did not receive the \$4.5 million from Boulware as a gift and a judgment that she held the money in constructive trust for HIE. App. 33-36. After a trial on the merits, the jury found that the monies were not gifts and belonged to HIE. App. 35-36. Similarly, "in deciding the equitable issues of unjust enrichment and constructive trust, the state court judge found by clear and convincing evidence that the monies were not gifts to Lee." App. 36. The state judge also found that the \$4.5 million "[is] the property of [HIE] which has been and

is being held in constructive trust by [Lee]" App. 36 (quoting state court judgment).

In 2001, the government obtained an indictment against Boulware, charging him with tax evasion and tax perjury. *See* 26 U.S.C. §§ 7201, 7206(2).¹ The tax counts alleged that Boulware failed to report as income approximately \$10 million that he allegedly diverted from HIE, including the \$4.5 million at issue in the state court counterclaim. ER 23, 521.² The government contended at trial that Boulware had converted the \$4.5 million that he transferred to Jin Sook Lee and that the money thus constituted income to him. Boulware countered that the funds belonged at all times to HIE and that Lee had received the money to hold in trust for the company. To support this position, Boulware sought to use the state court judgment establishing that the funds belonged to HIE. The district court refused to give the judgment binding effect and excluded it from evidence.

Following a guilty verdict, a panel of the Ninth Circuit reversed Boulware's conviction. The court held that the district court erred in excluding the state court judgment. App. 33-52. Although the court of appeals reversed Boulware's tax convictions on this basis, it declined to give binding effect to the Hawaii court's determination that the \$4.5 million belonged to HIE, because (according to the court) "the ownership of the money as between Boulware and HIE does not appear to have been subject to adversarial testing." App. 42.

¹ The indictment also charged Boulware with making false statements to a federally insured financial institution and conspiracy to make false statements. Those charges are not at issue here.

² The Excerpts of Record from the court of appeals are cited as "ER." The Appendix to this petition is cited as "App."

At the retrial, the district court admitted the Hawaii judgment into evidence. The court instructed the jury that "[t]he state court judgment received into evidence determined that the money that the defendant transferred to his girlfriend, Jin Sook Lee, was not a gift, and remained the property of Hawaiian Isles Enterprises." App. 25. But the court added, over Boulware's objection, ER 807-09, that "[t]hat determination is not binding on you," App. 25. The instruction thus left the jury free to disregard the state court judgment that \$4.5 million of the funds at issue belonged to HIE. The government emphasized this point in its rebuttal argument; it told the jury that the state court judgment "doesn't determine anything at all for you, ladies and gentlemen." Tr., Vol. 10, at 200.

As part of his defense at the retrial, Boulware sought to negate the "tax deficiency" and false statement elements of the tax evasion and tax perjury charges by presenting evidence that the money he received from HIE constituted nontaxable returns of capital he had invested in the company. ER 259, 369, 372, 540-48, 608, 629-30. Citing *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), the district court concluded that, to obtain admission of the evidence, Boulware had to show that the corporate distributions were intended as returns of capital at the time they were made. Because Boulware could not make this showing, the court precluded his evidence and refused to give a return of capital jury instruction. *E.g.*, App. 16-18, 21-23.

The jury found Boulware guilty. The district court sentenced him to 60 months incarceration. He appealed.

On December 13, 2006, the court of appeals affirmed Boulware's conviction and sentence. Because Boulware's proffered evidence in support of his return of capital defense did not satisfy the *Miller* contemporaneous intent

requirement, the court concluded that the district court did not err in excluding that evidence and in refusing to instruct on the defense. App. 3-6. The court recognized that under *Miller* the return of capital rule applies differently in criminal cases than in civil cases. It also acknowledged that its approach conflicts with decisions from the Second Circuit. App. 5-6. Concurring, Judge Thomas observed that if the panel were "writing on a clean slate, rather than under the controlling precedent of [*Miller*], I would adopt the approach of the Second Circuit concerning the return to capital defense." App. 13.

The court of appeals also reaffirmed its view that the state court judgment that the \$4.5 million belonged to HIE was not entitled to binding effect and thus that the district court's instruction on the judgment was not error. App. 11-12. The court denied a timely petition for rehearing en banc on April 23, 2007. App. 63.

REASONS FOR GRANTING THE WRIT

The Court should grant the writ to resolve two unsettled issues that are critical to the administration of the tax laws, particularly in criminal cases: (1) the effect of a final, non-collusive state court judgment adjudicating ownership of property on the determination of a taxpayer's income tax liability for that property, and (2) whether a taxpayer who seeks to invoke the return of capital rule in a criminal tax case must show a contemporaneous intent to treat the corporate distribution at issue as a return of capital, as the Ninth Circuit held here and in *Miller*, or merely meet the statutory requirements under 26 U.S.C. §§ 301 and 316, which do not include contemporaneous intent, as the Second Circuit holds.

I. THE COURT SHOULD GRANT THE WRIT TO CLARIFY THE EFFECT OF STATE COURT JUDGMENTS IN FEDERAL TAX CONTROVERSIES.

This Court has held that "federal income tax liability follows ownership," and "[i]n the determination of ownership, state law controls." *United States v. Mitchell*, 403 U.S. 190, 197 (1971); *see also, e.g., United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985) (noting that "state law controls in determining the nature of the legal interest which the taxpayer had in the property"); *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960) (in determining whether a taxpayer had property or right to property to which federal tax lien could attach, a federal court "must look to state law, for it has long been the rule that in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property . . . sought to be reached by the statute") (quotation omitted).

Although these cases establish that state *law* controls the determination of ownership in federal tax cases, the effect of state court *judgments* is less clear. This Court has left no doubt that a federal court deciding a tax case must give controlling effect to a decision of the highest court of a state resolving the property rights at issue. *See Commissioner v. Bosch*, 387 U.S. 456, 465 (1967). But the effect of a decision by a lower state court is unclear. In *Blair v. Commissioner*, 300 U.S. 5 (1937), the Court declared that a ruling by an intermediate state appellate court on issues relating to a trust "is final" in a federal tax case. *Id.* at 8-9. And in *Freuler v. Commissioner*, 291 U.S. 35 (1934), the Court found that the decision of a state trial court, "until reversed or overruled, establishes the law of California respecting distribution of the trust estate. It is none the less a

declaration of the law of the State because not based on a statute, or earlier decisions. The rights of the beneficiaries are property rights and the court has adjudicated them." *Id.* at 45.

These cases seem to give decisive effect for federal tax purposes to non-collusive state court judgments adjudicating rights in property. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), however, clouds the picture. Although *Bosch* affords decisive effect to rulings of a state's highest court, it declares that federal courts should merely give "proper regard" to decisions of lower state courts. *Id.* at 464-65. The Court observed that "if there be no decision by [the state's highest court] then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court." *Id.* at 465.³ *Bosch* did not explain how much deference, if any, "proper regard" for a lower state court decision entails.

Bosch appears to turn on the legislative history of the estate tax provision at issue and to be limited to that specific context. *See id.* at 464. Nevertheless, the lower federal courts have expressed uncertainty about how broadly its rule sweeps. The Fifth Circuit, for example, observed that "[t]he precise scope and meaning of *Bosch* as applied in dissimilar contexts is difficult for us to ascertain." *Estate of Warren v.*

³ Somewhat inexplicably, *Bosch* observed: "It may be claimed that *Blair v. Commissioner*, 300 U.S. 5 (1937), dealt with the problem presently before us but that case involved the question of the effect of a property right determination by a state appellate court." *Bosch*, 387 U.S. at 462 n.3. But *Blair* involved a decision by the Appellate Court of Illinois--an intermediate appellate court, below the Illinois Supreme Court--and the decree in the case was entered, under mandate from the Appellate Court, by a state trial court. *See Blair*, 300 U.S. at 8-10. Thus, *Bosch* and *Blair* appear to conflict.

Commissioner, 981 F.2d 776, 781 (5th Cir. 1993); *see, e.g., Estate of Delaune v. United States*, 143 F.3d 995, 1001 (5th Cir. 1998) (referring to the "rather ambivalent majority opinion in *Bosch*"). Similarly, the Ninth Circuit, in deciding Boulware's first appeal, noted that "[w]hat effect, if any, *Bosch* has outside the context of the estate tax statute is unclear." App. 40.

This case provides an opportunity for the Court to clarify the scope of *Bosch*. As noted above, "federal income tax liability follows ownership," and "[i]n the determination of ownership, state law controls." *Mitchell*, 403 U.S. at 197. Here, a final state court judgment, obtained through an adversarial, non-collusive trial, squarely determined that HIE owned money that the government claimed Boulware should have reported as personal income. If *Freuler* and *Blair* control, the state judgment precludes prosecution of Boulware for failing to pay taxes on the money and to report it as income. If *Bosch* controls, by contrast, the judgment is entitled only to "proper regard," whatever that phrase may be determined to mean. The Court should resolve the tension between these two lines of cases.

The Ninth Circuit rested its refusal to give the state court judgment conclusive effect on its observation that "the ownership of the money as between Boulware and HIE does not appear to have been subject to adversarial testing." App. 42. But this rationale raises further unresolved questions under *Freuler*, *Blair*, and *Bosch*. As the Fifth Circuit has noted, federal courts have given controlling effect in some settings even to "bona fide settlements of adversarial litigation not instituted for tax purposes." *Estate of Warren*, 981 F.2d at 781. It is hard to see why the fully litigated judgment in the state court action among Boulware, HIE, and Lee should receive any less effect than a settlement, even if

Boulware and HIE did not expressly litigate the ownership of the funds as between each other.

Moreover, the court of appeals ignores the significance of Hawaii principles of claim preclusion. Boulware and HIE were both parties to the state court proceeding. Under Hawaii law, "the judgment of a court of competent jurisdiction is a bar to a new action in any court between the same parties or their privies concerning the same subject matter, and precludes the relitigation, not only of the issues which were actually litigated in the first action, *but also of all grounds of claim and defense which might have been properly litigated in the first action but were not litigated or decided.*" *Bremer v. Weeks*, 85 P.3d 150, 160 (Haw. 2004) (emphasis added); *see, e.g., Foytik v. Chandler*, 966 P.2d 619, 626 (Haw. 1998) (same). Because any claim of ownership Boulware had against HIE concerning the \$4.5 million "might have been properly litigated" in the state court action with HIE and Lee, Boulware cannot challenge the judgment that the money belongs to HIE. The judgment in favor of HIE thus conclusively determines the property rights in the \$4.5 million not only between HIE and Lee, but also between HIE and Boulware. Just as Boulware cannot obtain the benefits of HIE's \$4.5 million, he should not be held responsible, criminally or civilly, for not paying federal income tax on that money.

Even if the Court were to agree with the court of appeals that *Bosch* controls under these circumstances, rather than *Frueler* and *Blair*, it should clarify the "proper regard" that the federal court must show to the lower state court judgment. The district court's instructions simply told the jury that the state court determination that the funds remained the property of HIE "is not binding on you." App. 25. The instruction did not require the jury to give "proper regard" to the state judgment, much less explain how much

deference the "proper regard" standard mandates. Nor did either the district court or the court of appeals perform the task that *Bosch* appears to contemplate: to "sit[] as a state court" and predict how the Hawaii Supreme Court would decide the ownership issue under state law. 387 U.S. at 465.

II. THE COURT SHOULD GRANT THE WRIT TO RESOLVE THE SPLIT IN THE CIRCUITS OVER THE RETURN OF CAPITAL RULE.

The Court should also grant the writ to resolve the split between the Second and Ninth Circuits over the application of the return of capital rule in criminal cases.

As the court of appeals recognized, "an essential element of the crime of tax evasion is the existence of a tax deficiency." App. 3. To prove the tax evasion charges, therefore, the government had to establish that Boulware owed taxes based on income he failed to report. Similarly, to prove the tax perjury charges, the government had to show that Boulware falsely understated his income. App. 53. Under the government's theory, the unreported income at issue on all counts consisted of money Boulware obtained from HIE. *E.g.*, ER 495-520.

To negate the "tax deficiency" and false statement elements of the charges, Boulware sought to establish that the money he received from HIE constituted returns of the capital he had infused into the company. When a corporation without earnings or profits distributes funds to a shareholder, the distribution is a nontaxable return of capital, up to the shareholder's basis in his stock. *See, e.g., United States v. Bok*, 156 F.3d 157, 162 (2d Cir. 1998); *United States v. D'Agostino*, 145 F.3d 69, 72-73 (2d Cir. 1998). The United States Tax Court recognized this principle in *Truesdell v. Commissioner*, 89 T.C. 1280, 1294-95 (1987).

The return of capital rule follows directly from the relevant provisions of the Internal Revenue Code. Section 301(a) of Title 26 declares that distributions by a corporation to a shareholder with respect to its stock "*shall*" be treated as provided in § 301(c), with exceptions not applicable here. 26 U.S.C. § 301(a) (emphasis added). Section 301(c) divides corporate distributions into dividends (as defined in 26 U.S.C. § 316), which are taxable as ordinary income, and non-dividends, which are taxable as capital gains to the extent they exceed the taxpayer's basis in his stock but are otherwise nontaxable. 26 U.S.C. § 301(c). Section 316 defines dividends as any distribution by a corporation to a shareholder "out of its earnings and profits." 26 U.S.C. § 316. Read together, these statutes establish that when a corporation without earnings or profits distributes funds to a shareholder up to the shareholder's basis in his stock, the distribution is a nontaxable return of capital. *See Bok*, 156 F.3d at 162.

In accordance with this rule, Boulware proffered expert and lay testimony that for the years at issue HIE had no earnings or profits and the money Boulware received constituted a nontaxable return of capital. *E.g.*, ER 369, 372, 540-48, 608, 629-30. Boulware also requested a return of capital jury instruction that correctly stated the principles outlined above. ER 259.

The district court prohibited Boulware from presenting evidence to support his return of capital defense. Relying on *Miller*, the court declared that "[t]he defendant must not show merely that the funds could have been a return of capital; he must introduce evidence showing that, at the time of the transfer, the funds were, in fact, a return of capital." App. 21; *see* App. 18 ("[I]f the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions were intended to be a

return of capital.""). Thus, the court required a showing of intent on the part of Boulware or HIE *at the time of the distributions* to treat them as returns of capital. Because the court found that Boulware's proffer did not meet this contemporaneous intent standard, it barred him from presenting any supporting evidence, *e.g.*, App. 21-23; ER 746, and it refused to instruct the jury on the return of capital defense.

The court of appeals affirmed. It declared that "[l]ike the defendant in *Miller*, Boulware 'presented no concrete proof that the amounts were considered, intended, or recorded on the corporate records as a return of capital at the time they were made.'" App. 6 (quoting *Miller*, 545 F.2d at 1215).

The court of appeals' holding, like *Miller* itself, ignores the plain terms of 26 U.S.C. §§ 301 and 316. These statutes make clear that a corporate distribution to a shareholder not out of earnings and profits is nontaxable to the extent of the taxpayer's basis in the stock. *See, e.g., Bok*, 156 F.3d at 162. Sections 301 and 316 turn entirely on objective circumstances--whether the corporation had earnings or profits for the year in question and the taxpayer's basis in his stock. The statutes say nothing about the intent of the corporation or the taxpayer at the time of the distribution. The *Miller* court invented this requirement out of whole cloth.

As Judge Thomas recognizes in his concurrence, the *Miller* contemporaneous intent requirement produces an illogical anomaly: corporate distributions that do not count as income for civil tax purposes under the return of capital rule *do* count as income for purposes of the tax evasion and tax perjury statutes. App. 13-14. Thus, under the Ninth Circuit's approach, a shareholder who has no income under

26 U.S.C. § 301(c) and *Truesdell* and who therefore has no tax liability could nevertheless be found to have a "tax deficiency" under 26 U.S.C. § 7201 and to have falsely reported his (nonexistent) income under 26 U.S.C. § 7206(2). In other words, in the civil setting, a corporate distribution is a nontaxable return of capital, regardless of the intent of the taxpayer and the corporation at the time of the distribution, as long as the corporation has no earnings or profits and the distribution does not exceed the taxpayer's basis in his stock. But according to the Ninth Circuit, that same distribution constitutes taxable income for purposes of a criminal prosecution unless the taxpayer can show that, at the time of the distribution, he and the corporation intended a return of capital. Thus, the contemporaneous intent requirement "result[s] in a logical fallacy, [and] is in flat contradiction with the tax evasion statute's requirement of 'the existence of a tax deficiency.'" App. 13-14 (Thomas, J., concurring).

The court of appeals' decision conflicts squarely with the Second Circuit's decisions in *Bok* and *D'Agostino*. Those cases hold that

in return of capital cases . . . the taxpayer or the corporation *need not have described the distribution at issue as a dividend or a return of capital at the time it was made*; rather, the realities of the transaction--including the amount of the shareholder's basis and the corporation's earnings or profits, as well as the amount of the distribution--govern its characterization for tax purposes.

Bok, 156 F.3d at 162 (citing *D'Agostino*, 145 F.3d at 72-73) (emphasis added).⁴ As Judge Thomas concludes in his concurrence, "the Second Circuit's analysis is more consistent with the statutory requirements of criminal tax evasion." App. 13.

Although Judge Thomas rejects the *Miller* contemporaneous intent requirement, he concludes that applying the return of capital rule here would not affect the outcome of this case. App. 14. We respectfully disagree.

First, Judge Thomas contends that the return of capital rule does not apply if the diversion of funds from the corporation was unlawful. App. 14. It is far from clear that this is correct; the relevant statutes (26 U.S.C. §§ 301 and 316) say nothing about the lawfulness of the corporate distribution. But even if such an exception to the return of capital rule exists, it has no bearing here. Judge Thomas asserts that "[b]ecause Boulware claimed that the diversions were made to defraud his ex-wife from her share of property in the divorce proceedings, these diversions may be properly considered unlawful." App. 14 (citing *Boulware*, 384 F.3d at 801). But the language Judge Thomas cites from *Boulware* does not support a finding that Boulware obtained the money from HIE to defraud his ex-wife, or even that he "claimed" to have done so.⁵ The district court made no finding that the distributions from HIE to Boulware were for that purpose, and the government never argued before the panel on appeal that the distributions were unlawful. And even if there were record support for Judge Thomas' contention, whether a

⁴ See also *United States v. Peters*, 153 F.3d 445, 460-61 (7th Cir. 1998) (noting split in circuits over return of capital defense).

⁵ Judge Thomas apparently cites to allegations in the Hawaii state court counterclaim that Boulware and HIE brought against Jin Sook Lee. But nothing in those allegations supports the proposition that Boulware diverted money from HIE to defraud his ex-wife.

corporate distribution can be considered unlawful so as to defeat the return of capital rule is a question of fact that the court of appeals should not decide in the first instance; the proper approach would be to remand for appropriate fact-finding in the district court.

Second, Judge Thomas asserts that the fact that Boulware was not the sole shareholder of HIE would "likely preclude him from asserting a return to capital defense." App. 14. In support of this contention, Judge Thomas notes that the courts in *Truesdell* and *Bok* applied the return of capital rule to distributions to sole shareholders. But 26 U.S.C. § 301(a) addresses distributions by a corporation to *a shareholder*, not distributions by a corporation to *the sole shareholder*. Nothing in *Truesdell* or *Bok* suggests that the return of capital rule is limited to sole shareholders. See, e.g., *Bok*, 156 F.3d at 162 ("We have long recognized that under certain circumstances monies lawfully withdrawn from a corporation by *one of its shareholders* may constitute a non-taxable return of capital." (citations omitted; emphasis added)). Contrary to Judge Thomas' view, therefore, overruling the *Miller* contemporaneous intent requirement in favor of the return of capital rule in *Bok* and *D'Agostino* would directly affect Boulware's case.

For these reasons, this case provides an appropriate vehicle for the Court to resolve the split between the Second and Ninth Circuits over the proper application of the return of capital rule in criminal tax cases. The Court should grant the writ and overrule the erroneous and illogical application of that rule in *Miller* and by the court of appeals below.

CONCLUSION

The petition for a writ of certiorari should be granted.

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