IRS COLLECTIONS: SON-OF-BOSS AND A SHAM DIVORCE, A TAX LIEN SOAP OPERA

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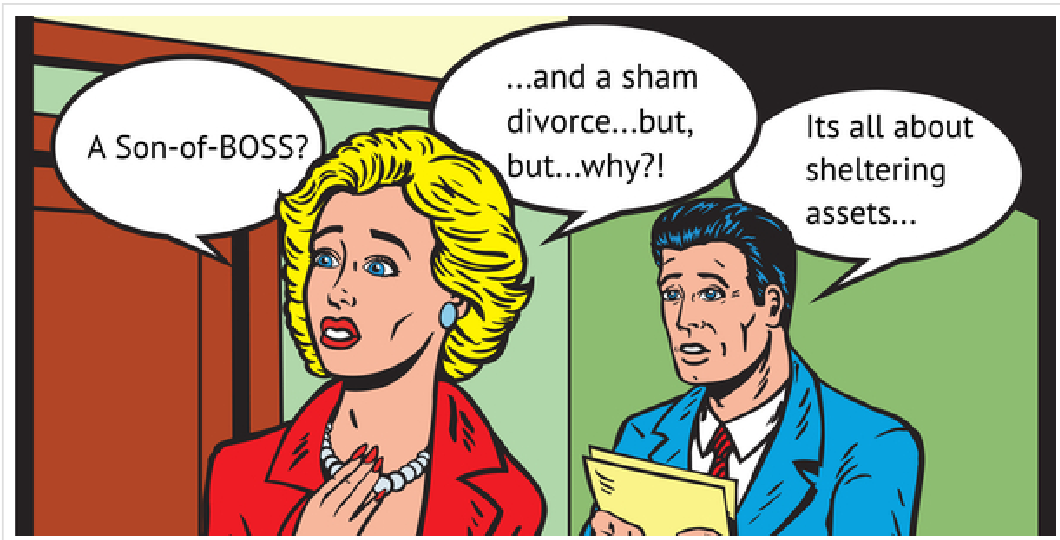

Some people will go to extraordinary measures to avoid paying their taxes. Recently, the First Circuit addressed a case where a business owner attempted to use a Son-of-BOSS tax shelter to avoid paying tax on gains from the sale of several fitness centers; when that did not work, he and his wife entered into a sham divorce, using the property settlement as a means to shelter assets from the IRS. *United States v. Baker*, No. 16-1415, 2017 U.S. App. LEXIS 5234 (Mar. 24, 2017). The Court of Appeals had to unravel a complex web of transactions to determine what property owned by the couple was subject to a federal tax lien.

In 2002, Scott Baker and a partner sold eight Planet Fitness gyms for roughly $15 million. *Baker*, 2017 U.S. App. LEXIS 5234 at *3. Baker received cash, plus stock in the acquiror, which he sold for $3.4 million; Mr. Baker used a Son-of-BOSS shelter to create losses and reported an overall loss of $2.5 million on his 2002 tax return. *Id.* Mr. Baker then amended his prior returns, carrying back the loss and receiving refunds of taxes paid between 1999 and 2001. *Id.* at *4.

In conjunction with his Son-of-BOSS shelter, Mr. Baker set up a trust in the Cayman Islands with the proceeds of the stock that he sold; he granted himself a one-third interest, and the remaining interests went to his wife, Robyn, as well as the couple's two children. *Id.* at *4-*5. The trust invested in a hedge fund, IMA, which was a Ponzi scheme. The Bakers learned that the fund was a Ponzi scheme in 2005; it filed for bankruptcy in 2006.

The Bakers purchased a home in Hingham, Massachusetts in August of 2005 as tenants by the entireties. The IRS opened an audit of Mr. Baker's 2002 return the same month. Although Mr. Baker agreed to participate in a settlement program for Son-of-BOSS participants, he was unable to pay the $1.2 million in taxes due under the settlement. *Id.* at *5. As a consequence, Mr. Baker was removed from the settlement program in 2007. *Id.*

In February 2007, the couple remortgaged the Hingham house, with Mr. Baker as the sole mortgagor. Then they set up a trust, the S & R Trust, with Robyn as the trustee, and they transferred title to the Hingham house to the trust. *Id.* at *6. The same day, they established a second trust with Robyn as trustee and the couple's children as beneficiaries; this trust received title to a beach house. Scott Baker received nothing in return for the transfers. *Id.*

In January 2008, the Bakers entered into a separation agreement and filed for divorce. Robyn received most of the property, including the right to any funds recovered in the Ponzi scheme bankruptcy. Scott assumed all of the debt, and retained his personal business interests. *Id.* at *7-*8. Scott also retained the right to reside in the Hingham house, and he testified that he paid the mortgage.

Although the couple had divorced, Mr. Baker never told his children about the divorce. *Id.* at *7-*8. The Bakers regularly vacationed with another couple who assumed they were married. And Mr. Baker allegedly assaulted a rival for his ex-wife's affection, gouging out his artificial eye. *Id.* at *8.

In May 2009, the IRS assessed Mr. Baker with taxes and penalties for 1997, 1998, and 2002; in May 2010, it issued assessments for 1999-2001 and filed tax liens to collect from Mr. Baker. *Id.* at *9.

In 2002, Scott Baker received a check for $202,000 payable to the Cayman Islands trust from the hedge fund's bankruptcy trustee. Scott turned over the check to Robyn, who invested the proceeds in a design business owned by a friend, which promptly hired Mr. Baker to do construction work. *Id.* The investment in this design business ultimately yielded $528,962.28.

In 2013, the government filed an action seeking to collect Mr. Baker's tax liabilities and to set aside the sequence of fraudulent transfers that the couple had made. *Id.* at *10. In connection with the litigation, the Bakers established an escrow fund to hold the $528,962.28 from the design business, along with another payment of approximately $70,000 received from the bankruptcy trustee. The district court concluded that Mrs. Baker was entitled to one-half of this fund as an equitable division of marital property after making certain adjustments between the Bakers. *Id.* at *12-*13.

When the case reached the First Circuit there were two open issues: The court had to address the appropriate disposition of the funds held in escrow, and it also had to address the government's lien tracing argument, which asserted that the United States had a lien on Robyn's share of the proceeds from the Hingham house because Scott had made mortgage payments after the government's tax liens arose.

Although the district court had concluded that the couple's divorce was a sham designed to cloak fraudulent asset transfers, the Court of Appeals nonetheless observed that the divorce was not invalid and that the district court was required to conduct an equitable division of the marital property. *Id.* at *14. As to the escrow fund, the court held that the district court had erred in allocating the fund because it had failed to consider the requisite factors under Massachusetts law. *Id.* at *14-*17.

On the lien tracing theory, the Court of Appeals rejected the government's assertion that it had a lien on Robyn's share of the proceeds from the sale, holding that the district court had properly refused to credit the Bakers' own testimony that Scott had regularly made payments to Robyn each month to be applied to the mortgage. Specifically, the court ruled that the Bakers' "equivocal testimony" was an insufficient basis to establish that specific payments were made by Mr. Baker towards the mortgage with funds subject to a federal tax lien: "We do not mean to hold that every time the government wishes to trace a lien it must be able to prove the amounts involved to the penny—but it should present the court with more than the testimony of witnesses who struggle with the truth." *Id.* at *19 (footnote omitted).

So the Bakers apparently managed to benefit from their own lack of credibility, which seems more than a little strange.

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