No. 20-690

IN THE

Supreme Court of the United States

MICHAEL SANG HAN,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the District of Columbia Circuit

REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

This case presents an opportunity to resolve a longstanding circuit split about the correct test for distinguishing taxable income from non-taxable loans under the Internal Revenue Code. Under this Court's precedent, loan proceeds are not income if there is a "consensual recognition, express or implied, of an obligation to repay." *James v. United States*, 366 U.S. 213, 219 (1961). But since *James*, several circuits have strayed from that straightforward approach, relying instead on numerous factors besides the parties' intent to determine whether a transfer constitutes income or a loan. In the decision below, the D.C. Circuit joined the circuits that apply these shapeless, multifactor tests. The Seventh Circuit expressly rejected that approach in *Busch v. Commissioner,* 728 F.2d 945, 948 (7th Cir. 1984), and the disagreement has become even more entrenched since then. The Government seeks to obscure this important and recurring question with a variety of arguments, all of which fail.

First, the Government incorrectly denies the existence of a split, insisting that all circuits apply a similar approach. *Busch* acknowledged the existence of the split, and the diverging tests applied by the courts of appeals can and do lead to inconsistent outcomes. Furthermore, this case implicates the split because the definition-of-a-loan issue was pressed by Petitioner below and passed upon by the D.C. Circuit.

Second, the Government misreads this Court's precedent in asserting that *James* does not identify intent as the defining element for distinguishing income from loans. This Court has twice reinforced

Petitioner's interpretation since *James*, as have the majority of the circuits.

Third, the Government errs in asserting that this case is not a proper vehicle for addressing this purely legal question. This case presents an excellent vehicle to resolve the split because resolution of the question presented is potentially dispositive—if the 2010 transfers were loans, Petitioner did not underreport his tax liability. And contrary to the Government's assertions, expert testimony and other evidence show that the error below was not harmless.

I. The Decision Below Implicates a Longstanding Circuit Split Regarding the Test for Distinguishing Non-Taxable Loans from Taxable Income.

A. The Courts of Appeals Apply Conflicting Frameworks.

The decision below deepens an entrenched split on the proper test to distinguish loans from income, and in doing so conflicts with the intent-based definition articulated in *James*.

Under the majority approach, applied by the First, Second, Fourth, Sixth, and Seventh Circuits—which faithfully adhere to *James*—the parties' intent to adopt a repayment obligation is the "sine qua non of a bona fide non-reportable loan," *United States v. Pomponio*, 563 F.2d 659, 662-63 (4th Cir. 1977), and other factors serve only as "indications of intent," *Busch*, 728 F.2d at 948. By contrast, the Third, Fifth, Ninth, and Tenth Circuits have deviated from *James* by employing a multifactor test in which intent to repay is only one of many non-dispositive factors. *See Busch*, 728 F.2d at 948 (collecting cases); Petition for Writ of Certiorari ("Pet.") 13-18.

The Government's position that there is no circuit split is untenable in light of that precedent. In the Government's view, the courts of appeals all "apply a broadly similar approach" in which "the intent of the parties that the borrower will repay the money is central." Brief in Opposition ("BIO") 20. But that argument misses the point: treating intent as "central" is not the same as treating it as the sole criterion.

The Seventh Circuit spoke directly to that issue in *Busch*. There, the court noted the circuit split and elected to follow the majority approach, viewing "objective factors [only] as indications of intent." 728 F.2d at 948; *see also United States v. Amick*, No. 99-4557, 2000 WL 1566351, at *4 (4th Cir. 2000) (rejecting jury instructions that "would have permitted the jury to discount intention to repay and place more emphasis on other factors" (citing *Pomponio*, 563 F.2d at 662)).

The Government concedes that some courts "have described factors other than direct evidence of intent as *separate considerations* in determining whether a purported loan is 'bona fide.'" BIO 21 (citing *Welch v. Comm'r*, 204 F.3d 1228, 1230 (9th Cir. 2000), and *Merck & Co. v. United States*, 652 F.3d 475, 480-86 (3d Cir. 2011)) (emphasis added). But *Busch* made clear that although "[a] court may look to various facts to determine intent, … once the taxpayer's intent is found, *that finding is conclusive of the legal issue of loans versus dividends*." 728 F.2d at 949 (emphasis added). Thus, by employing a multi-factor test in which intent is *not* dispositive, the minority of circuits, including the D.C. Circuit below, apply the intent-plus approach that *Busch* rejected.

The Government seeks to minimize this disagreement by pointing to the Ninth Circuit's citation of decisions from the First, Fourth, and Seventh Circuits in *Welch*. *See* BIO 21. But the Ninth Circuit's approach, cited by the D.C. Circuit below, looks beyond whether "the parties actually intended repayment" by "conside[ring] a number of other factors," none of which is "dispositive," in assessing whether a transaction is a "true loan." *Welch*, 204 F.3d at 1230. Thus, *Welch*'s reference to decisions from other circuits, while applying a multi-factor balancing test, only highlights the confusion regarding the correct approach and the need for this Court's intervention.

The Government likewise misses the mark in contending that the D.C. Circuit's reference to *United States v. McGinn*, 787 F.3d 116 (2d Cir. 2015), shows that the decision below is "wholly consistent" with *James* and the majority approach. BIO 17. Notwithstanding that citation, the D.C. Circuit applied an approach akin to the Ninth Circuit's multi-factor test by importing a second, independent factor into its analysis. Relying on *Welch*, the D.C. Circuit observed that "[w]hether a borrower has the intent *and ability to repay* a purported loan" are "factor[s] in judging whether the transaction is in fact a loan for tax purposes." Pet. App. 7a (emphasis added). The court then determined that evidence regarding Envion's business prospects was relevant because it suggested that Petitioner (1) "knew the deals he told the investors would be the source of their repayment would never be consummated" *and* (2) "did not have any independent money" with which he could repay the investors. *Id.* at 8a (citation omitted). Thus, the court weighed evidence of Petitioner's ability to repay—*i.e.*, his financial circumstances at the time of the transaction—on a co-equal basis with evidence regarding the parties' intent.

B. The Question Presented Was Both Pressed and Passed Upon Below.

Contrary to the Government's contention, Petitioner raised the definition-of-a-loan issue below. Petitioner's opening brief in the D.C. Circuit raised the question "[w]hether the District Court erred by failing to instruct the jury as to the definition of a personal loan." Pet. C.A. Opening Br., Dkt. No. 1808727, at 4. Petitioner likewise argued that, "[p]roperly instructed, the jury would have been informed that loan proceeds are not taxable when there is a 'consensual recognition, express or implied, of an obligation to repay.' *James v. United States*, 366 U.S. 213, 219 (1961)." Pet. C.A. Opening Br. at 43.[1]

Further, the D.C. Circuit passed upon this issue. Regarding Petitioner's evidentiary challenge, the decision below twice refers to "intent and ability to repay" as relevant "factor[s]." Pet. App. 7a-8a (citing *Welch*). This incorrect definition undergirds the court's evidentiary analysis: the only way the D.C.

[1] *See also id.* at 39 (Petitioner was "entitled to instructions explaining … how personal loans are defined"), 41 (District Court "should have … provided the jury with guidance on how to determine whether the funds received were proceeds of bona fide personal loans").

Circuit could assess the relevance of the challenged evidence was to apply the *law* they relate to.

With respect to Petitioner's jury-instruction challenge, the D.C. Circuit held that any omitted instruction was "harmless" because trial testimony was an adequate substitute. Pet. App. 9a-10a. Thus, the D.C. Circuit's analysis assumes that what the jury heard about loans was correct—an assumption Petitioner disputed below. Once again, the only way the D.C. Circuit could assess whether testimony was an adequate substitute for correct jury instructions was to compare the testimony with the governing law. By holding that the jury was not confused about the proper legal test, the D.C. Circuit necessarily passed on that issue.

C. The Government's Arguments Underscore the Recurring, Important Nature of the Question Presented.

The Government's brief provides little guidance regarding how loans are distinguished from income. The Government acknowledges that the tests applied by the courts of appeals differ from one another (while seeking to minimize the extent of these differences), *see* BIO 20-22, argues that *James* did not articulate a test, *see id.* at 19, and offers few details regarding what the Government believes is the proper approach. This lack of clarity illustrates the need for further review.

Indeed, the test for distinguishing loans from income arises frequently and affects a broad range of taxpayers. The persistent lack of certainty on that issue makes it difficult for taxpayers to plan their affairs and opens the door to unequal enforcement of the tax laws. *See* Pet. 21-22. Without a stable definition of a loan, taxpayers cannot confidently borrow or lend money. That issue affects not only commercial loans, but also informal lending arrangements among friends, family, and neighbors. The widespread, recurring nature of the question presented makes it particularly worthy of this Court's review.

II. *James* Established the Proper Approach for Distinguishing Loans from Income.

The Government dismisses the significance of the disconnect between *James* and the intent-plus approach applied by courts on the short end of the split, arguing that Petitioner "overreads *James*." BIO 17. Again, the Government is incorrect.

James lays out an overarching test for identifying taxable income, directing that "[w]hen a taxpayer acquires earnings, lawfully or unlawfully, *without the consensual recognition, express or implied, of an obligation to repay* and without restriction as to their disposition, 'he has received income which he is required to return.'" 366 U.S. at 219 (emphasis added) (quoting *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932)). Although "[t]his standard brings wrongful appropriations within the broad sweep of 'gross income,'" it also "excludes loans." *Id.*

The Government erroneously contends that *James* "'at most' described a 'consensual recognition, express or implied, of an obligation to repay' as a necessary condition for earnings to be deemed a non-taxable loan … not as a sufficient condition." BIO 19.[2] *James* recognized that a loan does not in itself constitute income to the borrower because any temporary economic benefit derived from the borrower's use of the funds is offset by the corresponding obligation to repay them. *See* 366 U.S. at 219; *see also Comm'r v. Indianapolis Power & Light Co.,* 493 U.S. 203, 207-08 (1990). Only when it is apparent that there is no intent to repay does a transaction come "within the broad sweep of 'gross income.'" *James*, 366 U.S. at 219; *see also Buff v. Comm'r*, 496 F.2d 847, 848 (2d Cir. 1974) ("the lack of consensual recognition of an obligation to repay" "distinguish[es] embezzlement from a loan"); B. Bittker & L. Lokken, *Federal Taxation Of Income, Estates And Gifts* ¶ 6.4 (3d ed. 2017) (noting the "theft-loan dichotomy" that *James*'s "consensual recognition of an obligation to repay" requirement seeks to enforce). Because the *James* test turns on intent, other considerations have no independent relevance. *See Busch*, 728 F.2d at 949; *Pomponio*, 563 F.2d at 662-63.

This Court's post-*James* decisions reaffirm that consensual recognition of an obligation to repay differentiates loans from income. In *Indianapolis Power & Light Co.*, for example, the Court cited *James* in holding that refundable security deposits paid to a utility company were not income to the company because these payments, like loans, were "acquired subject to an express 'obligation to repay.'" 493 U.S. at 207-12 (finding that evidence of unfettered use of the funds at issue, failure to segregate the funds, and lack of a

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[2] Even if intent to repay were merely a necessary condition under *James*, as the Government contends, that framework would still be incompatible with multi-pronged tests in which no factor—including intent—is dispositive, *see Welch*, 204 F.3d at 1230.

definite period for repayment were not dispositive because these factors had no bearing on the borrower's obligation to repay). Likewise, in *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983), the Court affirmed that "[w]hen a taxpayer receives a loan, he incurs an obligation to repay … [b]ecause of this obligation, the loan proceeds do not qualify as income to the taxpayer."

Petitioner's reading of *James*—*i.e.*, that "consensual recognition" of an obligation to repay is the "sine qua non of a bona fide non-reportable loan," *Pomponio*, 563 F.2d at 662—also mirrors the conclusion reached by most courts of appeals. *See, e.g.*, *Collins v. Comm'r*, 3 F.3d 625, 631 (2d Cir. 1993) ("Loans are identified by the mutual understanding between the borrower and lender of the obligation to repay and a bona fide intent on the borrower's part to repay the acquired funds." (citing *James*)); *United States v. Beavers*, 756 F.3d 1044, 1057 (7th Cir. 2014) ("the recipient must actually intend to repay" for a transaction to qualify as a loan); *Webb v. IRS*, 15 F.3d 203, 208 (1st Cir. 1994) (applying *James* "consensual recognition" test).

The Government incorrectly asserts (at 19) that *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), which predates *James*, "approved considering multiple factors in evaluating whether a transaction constitutes a bona fide loan." That argument is difficult to square with the language of *James* or the body of precedent that has developed since. To the extent *John Kelly* remains relevant, it suggests a possible conflict within this Court's own jurisprudence, underscoring the need for clarification. Regardless, neither the jury nor the D.C. Circuit considered or applied the *John Kelley* standard in the proceedings below.

III. This Case Is a Proper Vehicle for Resolving the Question Presented.

Although the Government argues that this case is a poor vehicle to clarify the test for distinguishing loans from income, that objection does not withstand scrutiny.

First, this case implicates a longstanding circuit split, and the issue was both pressed and passed upon below. Accordingly, there are no procedural impediments that would prevent the Court from reaching and deciding the question presented.

Second, resolution of the split is potentially dispositive on every element of the charges in this case—if the 2010 transfers to Petitioner were non-taxable loans, there would be no tax due, no affirmative act, and no willful evasion. *See* Pet. 4. The Government disagrees, contending that the question presented has no bearing on the outcome because the evidence would dictate a guilty verdict under any version of the loans-versus-income test. *See* BIO 22-23. However, that argument overlooks evidence that would have permitted the jury—had it been properly instructed—to find Petitioner not guilty on the ground that the transfers were non-taxable loans. For example, in contrast to earlier transactions that clearly identified Envion as the recipient, the 2010 loan documents (i) identified Petitioner as the borrower, (ii) were signed by Petitioner in his personal capacity, and (iii) caused funds to be wired to Petitioner's personal account. Pet. App. 3a, 47a, 54a, 61a, 71a, 78a. As Petitioner's expert testified, these facts support a conclusion that the 2010 transfers were personal loans that Petitioner had a duty to repay, and that accordingly did not generate tax liability. Pet. App. 45a.[3]

Without an instruction regarding how to distinguish non-taxable loans from taxable income, the jury lacked the framework necessary to evaluate the evidence. The D.C. Circuit concluded that the District Court's failure to issue a jury instruction was harmless error because the jury heard testimony and attorney argument that personal loans are not taxable. Pet. App. 10a. But the only guidance the jury received on that issue was the testimony of a Government witness who addressed several factors *in addition* to intent. *See* Pet. 7-8, 10, 20; Pet. App. 35a-37a. The D.C. Circuit's conclusion that the error was harmless was thus premised on the court's improper adoption of the minority approach for distinguishing loans from income. *See* Pet. App. 7a-8a. In light of the evidence addressed above, there is a reasonable likelihood that the District Court's instructional error was *not* harmless under the proper (i.e., intent-only) test.[4]

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[3] True, the record *also* contains evidence—cited by the Government—suggesting that the 2010 transfers were investments in Envion and that Petitioner's use of the funds constituted taxable income. Even so, the key point is that the evidence is sufficiently mixed that the verdict would not have been a foregone conclusion if the jury had been properly instructed.

[4] The Government overstates the significance of other evidence tending to support the decision below. For example, the global promissory notes and stipulation cited by the Government are not dispositive because they occurred after the 2010 transfers and thus are not indicative of the parties' intent *at the time of transaction*—the relevant issue under *James*. *See, e.g.*, *Saigh v.*

*   *   *

The Government's brief in opposition, much like the Government's arguments in the District Court and the D.C. Circuit, places heavy emphasis on the facts. That approach obscures significant *legal* uncertainty regarding the proper test for determining whether the 2010 transfers were taxable income or non-taxable loans. That uncertainty has plagued this case from the outset, and it affects a broad swath of other transactions—ranging from commercial agreements to informal loans among neighbors—as well. The question whether intent is the sole relevant factor has been subject to a deep and entrenched circuit split since the Seventh Circuit decided *Busch*, and that issue is squarely presented here. The time has come for this Court to resolve the matter.

CONCLUSION

For the foregoing reasons, and those stated in the Petition, the Petition should be granted.

Respectfully submitted,

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Comm'r, 36 T.C. 395, 420 (1961); *see also* Court of Appeals Appendix, Dkt. No. 1808728, at A267-69 (expert testimony addressing facts cited by the Government and adhering to conclusion that 2010 transfers did not generate taxable income).

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