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6 **IN THE UNITED STATES DISTRICT COURT**
7 **FOR THE DISTRICT OF ARIZONA**
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9 Aloe Vera of America Incorporated, et al.,

10 Plaintiffs,

11 v.

12 United States of America,

13 Defendant.
14

No. CV-99-01794-PHX-JAT

**FINDINGS OF FACT AND
CONCLUSIONS OF LAW**

15 The United States and Japan are parties to a tax treaty that permits the Internal
16 Revenue Service (“IRS”) to disclose to Japan, for purposes of preventing international
17 tax evasion, the tax return information of an American taxpayer.¹ The treaty does not
18 authorize, however, the disclosure of tax return information known to be false, and the
19 United States has waived sovereign immunity from liability for its unauthorized
20 disclosure of tax return information. The issue presented is whether and to what extent
21 the United States is liable for allegedly making knowingly false statements to Japanese
22 tax authorities during a joint investigation of Plaintiffs’ tax returns.

23 The first alleged false statement of the United States is an assertion that Plaintiffs
24 had unreported income properly taxable by the United States. The second alleged false
25 statement is that transfer prices between Plaintiffs’ Japanese and American entities did
26 not correlate over time with certain commissions paid by one Plaintiff to two other
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28 ¹ Convention for the Avoidance of Double Taxation and Prevention of Fiscal
Evasion with Respect to Taxes on Income, U.S.-Japan, Mar. 8, 1971, 23 U.S.T. 967.

1 Plaintiffs. For the reasons that follow, the Court concludes the United States made the
2 first statement while knowing it to be false, but did not know the second statement to be
3 false at the time of its utterance. Because Plaintiffs cannot show the false statement
4 caused actual damages, the Court awards statutory damages of \$1,000 to each of three
5 Plaintiffs.

6 **I. Procedural History**

7 Plaintiffs Aloe Vera of America, Incorporated; Rex G. Maughan; Ruth G.
8 Maughan; Maughan Holdings, Incorporated; Gene Yamagata; and Yamagata Holdings,
9 Incorporated (collectively, “Plaintiffs”) sued the United States for unauthorized
10 disclosure of tax return information under 26 U.S.C. § 7431(a)(1) after the Japanese
11 media reported that a company owned by Plaintiffs, Forever Living Products Japan, Ltd.,
12 had committed tax evasion.

13 The operative complaint is Plaintiffs’ Third Amended Complaint (Doc. 405), in
14 which Plaintiffs alleged two counts against the United States: In Count I, Plaintiffs
15 alleged the United States disclosed false tax return information concerning Plaintiffs to
16 the Japanese tax authorities and the United States knew or should have known that this
17 information was false. (Doc. 405 at 14). In Count II, Plaintiffs alleged the United States
18 knew or should have known at the time of disclosing Plaintiffs’ tax return information to
19 the Japanese tax authorities that those authorities routinely did not keep such information
20 confidential within the terms of the tax treaty. (*Id.* at 16-17).

21 Although the United States was unsuccessful in having this case dismissed on the
22 issue of subject-matter jurisdiction, *see* (Doc. 65), the Court ultimately granted summary
23 judgment in the United States’ favor, concluding that Plaintiffs had failed to establish the
24 existence of a genuine issue of material fact on either Count I or Count II of the Third
25 Amended Complaint. *Aloe Vera of Am., Inc. v. United States*, 2007 WL 329111, at *5, 8
26 (D. Ariz. Feb. 2, 2007). On appeal, the Ninth Circuit Court of Appeals (“Court of
27 Appeals”) remanded for a determination of subject-matter jurisdiction based upon the
28 statute of limitations. *Aloe Vera of Am., Inc. v. United States*, 580 F.3d 867, 873 (9th Cir.

1 2009). The Court found it had jurisdiction over some claims, but reaffirmed its judgment
2 in favor of the United States for the reasons stated in its previous summary judgment
3 ruling. *Aloe Vera of Am., Inc. v. United States*, 730 F. Supp. 2d 1020, 1035-36 (D. Ariz.
4 Aug. 3, 2010).

5 On a second appeal, this time concerning the merits of the summary judgment
6 ruling, the Court of Appeals affirmed in part and reversed in part, holding that genuine
7 issues of material fact existed on Count I of Plaintiff's Third Amended Complaint. *Aloe*
8 *Vera of Am., Inc. v. United States*, 699 F.3d 1153, 1166 (9th Cir. 2012). Following
9 remand, the United States moved for partial summary judgment, which the Court denied.
10 *Aloe Vera of Am., Inc. v. United States*, 2013 WL 6836603 (D. Ariz. Dec. 17, 2013). The
11 Court held a bench trial and the parties submitted post-trial briefs on all issues. (Docs.
12 695, 696, 700, 701).

13 Having considered the bench trial, closing arguments, and post-trial briefing, the
14 Court finds and concludes as follows:

15 **II. Findings of Fact**

16 **A. Background**

17 **1. Forever Living Products & Aloe Vera of America, Inc.**

18 Plaintiffs are involved in the international supply of aloe vera-based health and
19 beauty products. Plaintiff Rex G. Maughan is the founder of Forever Living Products, a
20 company that sells aloe vera products through multi-level marketing. Rex Maughan owns
21 and operates a number of related entities, including entities that are Plaintiffs in this case,
22 (collectively, the "FLP Group") that manufacture, process, market, and sell these aloe
23 vera-based products. The FLP Group is vertically integrated from the growing of aloe
24 vera plants through the marketing and sales of the finished health and beauty products.
25 FLP Group products are ultimately distributed worldwide through several million
26 independent distributors.

27 Plaintiff Aloe Vera of America, Incorporated ("AVA") is an S corporation
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1 incorporated in Texas and is wholly owned by Plaintiff Rex G. Maughan.² AVA is a
2 manufacturing company that processes raw aloe vera gel to create a stabilized product
3 with a shelf life that is then sold to other FLP Group entities for multi-level marketing.

4 **2. FLPJ**

5 Forever Living Products Japan (“FLPJ”) was founded in 1980 and is the FLP
6 Group entity responsible for the distribution and marketing of aloe vera products in
7 Japan. During the years relevant to this litigation, 1991 to 2005, Plaintiff Maughan
8 Holdings, Inc. (“MHI”) owned 50% of FLPJ and Plaintiff Yamagata Holdings, Inc.
9 (“YHI”) owned 50% of FLPJ. MHI is an S corporation incorporated in Arizona and is
10 wholly owned by Plaintiff Rex G. Maughan. YHI is an S corporation incorporated in
11 Nevada and is wholly owned by Plaintiff Gene Yamagata. MHI and YHI are both
12 holding companies for their respective owners.

13 FLPJ sells its products in Japan through multi-level marketing. Multi-level
14 marketing involves the use of distributors, who are independent contractors that purchase
15 product from FLPJ and sell it to consumers. Distributors earn income in two ways: First,
16 distributors directly sell FLPJ products to consumers at a price that is higher than the
17 distributors’ wholesale cost of purchase. Second, each distributor earns a percentage of
18 the sales of other distributors whom that distributor has recruited into the FLPJ marketing
19 program.

20 Rex Maughan and Gene Yamagata were the original distributors for FLPJ as well
21 as company officers and directors. Thus, they earned income from FLPJ in three ways: as
22 distributors (earning a percentage of the sales of “down line” distributors), as
23 compensation for services rendered as directors and officers, and in the form of dividends
24 through their ownership interests.

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27 ² It is unclear whether those entities owned by Rex G. Maughan are owned solely
28 by him, *see* (Doc. 669 at 5-6), or are owned by Rex G. Maughan and his wife, Plaintiff
Ruth G. Maughan, *see* (Tr. 46). This distinction is not at issue in the case and the Court
makes no findings on this point. References to “Maughan” to refer to Rex Maughan
unless otherwise specified.

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3. The Royalty Agreement Between FLPJ and AVA

AVA generally sells processed aloe vera products to the FLP Group entity responsible for marketing and sales in each country. However, Japan requires that a portion of the manufacturing process occur within its borders. Thus, AVA sells bulk raw aloe vera gel, rather than processed product, to FLPJ. A third party in Japan performs AVA’s proprietary stabilization and bottling processes, and FLPJ then distributes the processed products in Japan. FLPJ has been selling AVA’s product since the beginning of FLPJ’s sales in 1983.³

AVA has been the exclusive supplier of FLPJ’s aloe vera products since 1990 when the parties entered into a sales agreement. In the 1990 agreement, FLPJ agreed to purchase its raw aloe vera product exclusively from AVA. FLPJ also agreed to pay a royalty of 3.5% of its sales to AVA in exchange for the use of AVA’s technology to process the raw aloe vera gel. During 1991-2005, about 40% of AVA’s total sales were to FLPJ under this agreement.

4. Raw Aloe Vera Gel Prices and Commissions/Royalties from FLPJ to Maughan and Yamagata

The price for raw aloe vera gel between AVA and FLPJ varied over the years. From 1988 through February 1992, the price was \$18 per gallon. From March 1992 through the end of 1995, the price was \$20.90 per gallon. During the period from 1988 through 1995, AVA’s accounting included in its cost of goods sold to FLPJ a commission/royalty per gallon of aloe vera gel sold. The commission rate was \$8.10 per gallon from 1988 through February 1992, and \$11 per gallon from March 1992 through the end of 1995. AVA did not retain this commission but paid it directly or indirectly to Maughan and Yamagata in equal shares. AVA deducted this commission from its gross income as an ordinary and necessary business expense.

³ FLPJ was incorporated in 1980 but spent three years obtaining the necessary product and marketing plan approval before it commenced sales.

1 **5. Plaintiffs’ Prior Audits**

2 Plaintiffs were the subject of at least two prior audits before the audits and
3 examinations at issue in this case. First, in 1985, the National Tax Administration of
4 Japan (“NTA”), the agency responsible for the enforcement of Japan’s tax laws, audited
5 FLPJ with respect to the deductibility of compensation paid to FLPJ directors. Second,
6 the IRS audited AVA and the Maughans for the 1987-90 tax years. In the process of
7 examining the Maughans’ tax returns for the 1988-90 tax years, the IRS determined that
8 FLPJ had been paying royalties for the benefit of Maughan and Yamagata to an entity
9 named “Batrax” for the purpose of deferring tax liability.⁴ Additionally, an International
10 Examiner’s Report prepared for the 1988-90 tax years recommended disallowing
11 deductions taken by AVA for commissions paid by FLPJ to AVA and passed through to
12 Maughan and Yamagata.

13 **B. The IRS-NTA Simultaneous Examination**

14 **1. The Development of the Simultaneous Examination Proposal**

15 In May 1995, the IRS assigned Rick Smith, an international examiner, to examine
16 the international issues for the tax returns of Rex and Ruth Maughan. Smith’s
17 examination also included the tax returns of Forever Living Products and AVA. This
18 audit was for the 1991 and 1992 tax years and concerned payments made by FLPJ to
19 AVA. Smith produced an International Examiner’s Report in which he recommended
20 disallowing AVA’s deductions for the commissions paid by FLPJ to AVA and passed
21 through to Maughan and Yamagata; Smith recommended disallowing these deductions
22 (thus increasing AVA’s taxable income) to the extent of \$9,681,688 for the 1991 tax year
23 and \$23,668,075 for the 1992 tax year.

24 Sometime between May 1995 and January 1996, Charles Mason, Smith’s manager
25 and the manager of the IRS’s international group for the region including Arizona,
26 assigned Smith to draft a proposal to Japan that the IRS and NTA jointly and
27 simultaneously examine the tax returns of the Maughans and their related entities

28 ⁴ Section II.B.1, *infra*, contains a more detailed explanation of Batrax.

1 (including FLPJ and AVA) (the “Simultaneous Examination Proposal” or “SEP”). As the
2 primary author of the SEP and the international examiner assigned to the audits of the
3 Maughans, Smith’s goal for the proposed simultaneous examination was to discover
4 whether the taxpayers had any additional sources of income, unknown to the IRS, that the
5 taxpayers were funneling through an operation similar to Batrax to defer tax liability.

6 Smith was aware of the examinations for the 1988-90 tax years in which the IRS
7 discovered that FLPJ paid royalties to Batrax, a foreign entity, that were otherwise for the
8 benefit of Maughan and Yamagata. Instead of Maughan and Yamagata paying U.S.
9 income taxes on these royalties, Batrax held the royalties in foreign trusts for their
10 benefit. The effect was to defer any taxation on this income until Maughan and Yamagata
11 chose to bring the money into the United States.⁵

12 Smith had also encountered Batrax when he read documents from a 1990 lawsuit
13 between Maughan and Yamagata in which Yamagata alleged that Maughan used Batrax
14 as a scheme to evade reporting and paying U.S. income taxes. As part of his research,
15 Smith read a transcript from that lawsuit in which the structure of Batrax was explained
16 in detail, including the use of foreign entities and trusts to defer U.S. taxes. By the time
17 Smith drafted the SEP, however, he knew that Yamagata and Maughan had reported all
18 of their royalty income for the 1991 and 1992 tax years.

19 The IRS’s past examinations had revealed that there were other entities possibly
20 using Batrax as well. Smith had also conducted Internet research and read an article
21 suggesting that an aloe vera farm in the Philippines was related to the FLP Group. Smith
22 wanted to use the simultaneous examination to discover whether there were other aloe
23 vera farms outside of the United States that were unknown to the IRS and whether
24 income from any such farms was being structured through Batrax or an equivalent,
25 although he also believed that such unreported income might not exist.

26 Before Smith drafted the SEP, he reviewed the procedures in the Internal Revenue

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28 ⁵ Yamagata had always reported this income on his U.S. tax return; Maughan did
so after 1990 when he “brought in” all his deferred income. FLPJ’s use of Batrax ended
in 1990.

1 Manual (“IRM”) for simultaneous examinations. Smith generally followed the format
2 specified in the IRM for drafting a SEP. Part III of the SEP in both its final and draft
3 forms was titled “Estimated or Potential Additional Tax from Issues in Part II.” The
4 purpose of this section was to estimate the additional tax that could be assessed against
5 the taxpayers following the simultaneous examination on the topics listed in Part II. The
6 IRM provided as follows:

7 Part III of the format . . . endeavors to present the potential
8 benefits a Simultaneous Examination of a proposed case
9 would yield. In many cases, examinations may not have
10 progressed to a point where specific amounts, either of tax or
11 of adjustments to income, can be estimated. In such cases, it
12 should be plainly stated that no estimate can be made at this
13 stage of the examination. If an estimate is given, a brief
14 description of how the estimate was arrived at should be
15 provided.

16 Smith’s early drafts of the SEP did not include any numbers whatsoever in Part
17 III, including any numbers expressing an amount of estimated additional tax that could be
18 assessed as the result of a simultaneous examination. Smith listed all amounts in Part III
19 as unknown because at the time he believed the IRS’s examination had not progressed to
20 the point where a specific amount could be estimated; Smith did not know the extent or
21 even the existence of any unreported income.

22 When Smith submitted his draft SEP to Mason, however, Mason instructed Smith
23 that there had to be numbers in Part III. Smith responded to Mason that he could not
24 “really put numbers in there” and any estimates “would not be very good” because Smith
25 was looking for income that was not definitely known to exist, and accordingly Smith
26 had no basis for computing any such amount. Mason repeated to Smith that Smith had to
27 put numbers in the SEP, but the numbers had to be justified. Smith then asked Sally
28 Warner, the competent authority representative in the simultaneous examination program,
whether there had to be numbers in Part III. Warner—whom Smith believed to be an
expert on simultaneous examination procedures—told Smith that there had to be
numbers. Smith argued with Mason and Warner that the amounts should be listed as
unknown; Warner told Smith that nobody ever pays attention to the amounts in a

1 simultaneous examination and although they were important to convey an idea, they were
2 not a critically important part of the SEP.⁶

3 Subsequently, Smith used the sales of aloe vera gel to make an “estimate of
4 potential” for unreported income, which he listed in Part III of the SEP. He intended this
5 estimate (approximately \$32 million) to show potential adjustments to the taxpayers’
6 income from “unknown activities” including unreported income. Smith does not
7 remember the details of how he created this estimate, but he intended it to include the
8 possible aloe vera farm in the Philippines and any unknown entities similar to Batrax.⁷
9 Smith believed these unknown entities could create a potential for the approximately \$32
10 million of unreported income in his estimate. The estimate was not based on Smith’s
11 actual calculations of royalty/commission income paid to Maughan and Yamagata in
12 1991 and 1992 contained in his International Examiner’s Report, however.

13 The final draft of the SEP reflects the addition of Smith’s estimate (comprising
14 eight separate figures) and explanation for that estimate as follows:

15
16 Part III

17 1. Estimated or Potential Additional Tax from Issues in Part II:

18 Amounts are estimates based on sales of aloe vera gel to FLPJ during
19 1991 and 1992:

| | | |
|-----------------------------------|--------------|--------------|
| 20 For Internal Revenue Service: | 1991 | 1992 |
| 21 Unreported income of | \$10,616,000 | \$21,500,000 |
| 22 | | |
| 23 For Japan: | | |
| 24 Disallow royalty expense of | \$3,698,000 | \$7,000,000 |
| 25 Disallow commission expense of | \$6,918,000 | \$14,500,000 |

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27 ⁶ Warner did not believe that Part III was “necessarily” an important part of a
simultaneous examination proposal.

28 ⁷ Smith did not intend to create a large estimate merely to entice the NTA into
accepting the SEP and entering into a simultaneous examination.

1 examine Rex and Ruth Maughan as well as related entities AVA, Selective Art Inc.
2 (formerly Forever Living Products, Inc.), Forever Living Products International, and
3 FLPJ. In the letter, the IRS advised the NTA that a simultaneous examination could
4 discover evidence that the entities in each country were not reporting correct tax
5 liabilities.

6 The IRS attached its six-page Simultaneous Examination Proposal to the letter.
7 Part I of the SEP identifies the U.S. and Japanese entities to be subjected to examination,
8 lists the tax years involved (1991 and 1992), states that the IRS examination is already in
9 progress, and proposes that the simultaneous examination begin in May 1996 and
10 conclude by December 1996.

11 Part II of the SEP contains a factual background, including prior tax liability
12 history, of the entities proposed to be examined, a list of the principal factual and legal
13 issues, a list of the type and volume of information expected to be sought through the
14 IRS-NTA exchange of information, and a description of information and documents
15 obtained. The background section describes the ownership structure of FLPJ as 50% by
16 Maughan and 50% by Yamagata; it also lists a prior exchange of information between the
17 IRS and the NTA concerning tax years prior to 1991, the result of which was the
18 disallowance (it is unclear by whom) of certain royalty payments “accrued to Forever
19 Living Products (U.S.) and Batrax Rotterdam BV.” The factual and legal issues section
20 describes the structure and tax treatment of royalty payments made in the 1987 through
21 1990 tax years by FLPJ to Batrax Rotterdam BV (“Batrax”) for the benefit of Maughan
22 and Yamagata; FLPJ included these payments in its cost of goods sold despite their
23 payment to trusts for the benefit of Maughan and Yamagata. In particular, the SEP states
24 that “[t]he monies sent through Batrax for the benefit of Mr. Yamagata have been
25 reported by Mr. Yamagata on his U.S. income tax returns but the monies sent through for
26 Mr. Maughan have not been reported in the United States.”⁹ Part II also mentions

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28 ⁹ This statement was false with respect to Maughan. Smith knew Maughan had reported this income but inadvertently stated that he had not done so.

1 commissions paid by FLPJ to Maughan and Yamagata and the IRS asserts that these
2 commissions, despite FLPJ's classification as part of cost of goods sold, are in the nature
3 of dividends to shareholders.

4 Part III of the SEP contains an estimate of the potential additional tax to Japan and
5 the U.S. that could be assessed as a result of the simultaneous examination. (Although
6 Part III is at the core of this case, the Court has already block-quoted Part III in its
7 preceding discussion of the SEP's development and will not repeat it here.)

8 **3. Simultaneous Examination Meetings**

9 The NTA accepted the SEP, and on August 5-7, 1996, the IRS and NTA held a
10 simultaneous examination meeting in Phoenix, Arizona.¹⁰ Smith, Mason, and Warner
11 were present, along with other IRS officials including Pat Sturgis, a domestic Group
12 Manager working on the audit of the Maughans. During this meeting, the tax agencies
13 exchanged information including tax return information of some Plaintiffs. Both Warner
14 and Sturgis took notes of this meeting.

15 At one point during the meeting, Smith stated that the cost to FLPJ of raw aloe
16 vera gel changed over time while commissions to Maughan and Yamagata remained
17 constant.¹¹ This statement was memorialized in the notes of Sally Warner as:

18 Rick Smith commented that the U.S. team feels they are
19 doing other things in other countries because their sales are
20 going up and net income is going down. Rick also stated that
through the years the sales price of the product changed quite
a bit. The commission always stayed the same.

21 It was memorialized in the notes of Pat Sturgis as:

22 Cost of product to Japan changed over the years from over
23 \$30 to \$15 approx. but commissions always stayed the same
24 at \$8.10.

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26 ¹⁰ This was the third simultaneous examination ever conducted between the U.S.
and Japan.

27 ¹¹ Smith does not remember making this statement. The Court finds that the notes
28 of Sturgis and Warner, combined with their admitted weaknesses in the quality of their
notes, are insufficient to support a finding that Smith made this statement with any
greater specificity (such as specifying a particular time period).

1 This statement was false, although Smith does not remember making this
2 statement. Smith now recognizes that the statement was false, but at the time of
3 presenting to the NTA at the meeting, did not intend to make such a false statement.

4 After the meeting concluded, the IRS and NTA exchanged approximately two
5 hundred pages of documents containing tax return information that had been requested
6 during the meeting.

7 The IRS and NTA held a second simultaneous examination meeting on November
8 13-15, 1996 in Tokyo, Japan. At this meeting, the IRS disclosed additional information
9 and documents containing tax return information of some Plaintiffs.

10 **C. IRS and NTA Assessments**

11 In October 1996, the NTA initiated an audit of FLPJ for the 1991-95 tax years.
12 FLPJ had calculated its net income by deducting from sales its cost of goods sold (which
13 reflected FLPJ's cost of purchasing AVA's product). The NTA recharacterized FLPJ's
14 cost of goods sold by classifying part of it as nondeductible director bonuses and
15 assessing a "heavy penalty" (akin to a fraud penalty) for FLPJ's failure to report the
16 director bonuses.¹²

17 FLPJ met with the NTA numerous times from October through December 1996
18 concerning this audit. At these meetings, FLPJ attempted to convince the NTA that under
19 transfer pricing principles¹³ the amount charged by AVA to FLPJ was the correct,
20 marketable price for the raw aloe vera gel. However, at the December meeting, the NTA
21 reiterated that they did not agree with FLPJ; they were going to recharacterize a portion
22 of the cost of goods sold as director bonuses and assess a heavy fraud penalty.

23 FLPJ expected the proposed assessments to amount to approximately \$80 million.
24 It did not have the funds on hand, and the assessments had to be paid before FLPJ could

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26 ¹² Under Japanese tax law, annual bonuses or other non-monthly payments to
27 directors are nondeductible director bonuses.

28 ¹³ Transfer pricing concerns setting an appropriate price for goods sold between
related entities such that income is not shifted from one entity to another for purposes of
avoiding tax.

1 challenge their validity. Rick Toma, FLPJ's country manager, contacted two of FLPJ's
2 banks (Asahi and Sanwa) to inquire whether FLPJ could obtain a loan to pay the
3 assessments. Toma also shared the details of the proposed assessments with
4 approximately one hundred FLPJ employees, forty general managers, and ten President's
5 Club Members.¹⁴ Although FLPJ also drafted two press releases concerning the
6 assessments, it never issued them.

7 On January 20, 1997, the NTA issued correction notices to FLPJ for tax years
8 1991-95. These notices assessed additional tax, including penalties and interest, of
9 approximately 8 billion Japanese yen (approximately \$73 million). In the correction
10 notices, the NTA recharacterized a portion of FLPJ's cost of goods sold as nondeductible
11 director bonuses because AVA paid this amount to Maughan and Yamagata, and this thus
12 represented director compensation. FLPJ took out bank loans to pay these assessments.

13 On February 5, 1997, the IRS assessed AVA additional tax for tax years 1991 and
14 1992. The IRS disallowed AVA's deduction for commissions included in the sales price
15 of aloe vera gel to FLPJ and paid by AVA to Maughan and Yamagata, finding that these
16 commissions were not ordinary and necessary business expenses of AVA.

17 FLPJ, AVA, Maughan, and Yamagata immediately challenged the IRS's and
18 NTA's assessments. In March 1997, the FLP Group requested the U.S. Competent
19 Authority's assistance with the IRS and NTA assessments. The U.S. Competent
20 Authority took the position that the NTA's correction notices resulted in double taxation
21 of FLPJ and AVA, a result that the tax treaty with Japan seeks to avoid. AVA also
22 appealed the IRS's disallowance of the deduction for commissions paid to Maughan and
23 Yamagata.

24 In August 1997, the IRS appeals office conceded AVA's deductions for
25 commissions paid by AVA to Maughan and Yamagata. Specifically, the IRS determined
26 that the commissions paid by AVA to Yamagata and Maughan were ordinary and

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28 ¹⁴ FLPJ designates certain distributors as "President's Club Members" based upon
their sales volume.

1 necessary business expenses of AVA. However, the NTA maintained its position
2 concerning FLPJ with respect to the 1991-95 tax years and also extended its position to
3 the 1996 tax year.

4 In late 1997, the NTA initiated an audit of FLPJ for the 1996 tax year. As with the
5 1991-95 years, the NTA recharacterized a portion of FLPJ's cost of goods sold as a
6 nondeductible director bonus and assessed a heavy fraud penalty. This proposed
7 assessment was for approximately \$20 million.

8 On October 6, 1997, FLPJ met with the NTA¹⁵ concerning the 1996 audit. FLPJ
9 told the NTA that they were challenging the previous assessments, they were meeting
10 with the U.S. Competent Authority, and they had successfully contested the IRS's
11 disallowance of AVA's deduction for commissions. The NTA official was surprised to
12 learn that AVA had successfully challenged the IRS's disallowance of those deductions.
13 The NTA did not change their position at this meeting.

14 **D. The October 1997 Media Reports**

15 **1. Content**

16 On October 9-10, 1997, a series of news reports appeared in the Japanese media
17 concerning FLPJ. One report appeared in the television news program of NHK, a
18 Japanese broadcaster, and was followed by a number of articles in widely-circulated
19 newspapers. These reports varied slightly in content, but essentially conveyed the same
20 message as translated and summarized: As the result of a simultaneous tax examination
21 between the NTA and the United States, Forever Living Products Japan, the Japanese
22 arm of a multinational enterprise involved in the manufacture and sale of aloe vera
23 products, has been found to have concealed more than 7.7 billion yen of income by
24 inflating the price of raw aloe vera. The NTA assessed an additional tax of 3.5 billion yen
25 against FLPJ, including a "heavy penalty tax." The simultaneous examination was based
26 on information from U.S. tax authorities that FLPJ concealed its income. FLPJ greatly

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28 ¹⁵ Specifically, FLPJ met with the Tokyo Regional Taxation Bureau ("TRTB"), a
local division of the NTA.

1 padded the purchase price of raw aloe vera for the purpose of reducing its income. The
2 concealed income was remitted to FLPJ's affiliate in the U.S. When the U.S. tax
3 authorities examined FLPJ's affiliated company, they determined that the directors of the
4 U.S. affiliate had used the remitted funds for their own personal use and assessed an
5 additional tax. The simultaneous examination system under which the NTA and U.S.
6 carried out this investigation was initiated in 1986 for the purpose of preventing tax
7 evasion by organizations operating in both countries.

8 2. **Source**

9 There is conflicting evidence concerning the source of information for the media
10 reports. The media reports did not identify the source of their information by a formal
11 name. Each of the media reports used particular language (for example, the terms
12 "kankeisha" and "wakatta") to identify the source of the information contained in the
13 report. These Japanese terms have a cultural meaning beyond their literal definitions
14 when used in the media; they indicate that the source is the most authoritative and direct
15 source of information. In the context of an article concerning tax assessment, these terms
16 mean the NTA. Based upon these Japanese journalistic practices and the taxation subject
17 of the article, each of the media reports specifically identifies the NTA as the source of
18 information.

19 Furthermore, each of the newspapers who published a report on FLPJ was a
20 member of a NTA press club, through which the NTA disseminates information. The
21 media reports also contained facts not known to FLPJ, such as the fact that the
22 simultaneous examination began in 1996 and the number of previous simultaneous
23 examinations between the NTA and the IRS.¹⁶ Moreover, as of October 1997, the NTA
24 had a custom in domestic tax matters of leaking information to the media for the purpose
25 of shaming large or famous tax evaders. This was done to deter other tax evaders by
26 causing the public to feel morally compelled to comply with the tax code.

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28 ¹⁶ The articles are not consistent concerning this number, but it was unknown to
FLPJ.

1 U.S. Competent Authority Lyons took the position that the source of the media
2 reports could neither be proven nor disproven to be the NTA, but the IRS also created a
3 document for its internal use titled “Aloe Vera of America, Inc. / Summary of Case
4 Events” in which it stated that the “NTA leaked information to the Press concerning their
5 audit of FLPJ.”

6 The IRS had previously received complaints from taxpayers and practitioners
7 concerning Japanese disclosures of taxpayer information to the press, but according to
8 U.S. Competent Authority Lyons, none of these were ever proved to be more than rumor.
9 Some IRS officials had privately expressed to Lyons that NTA leaks to the media
10 appeared to happen on every high-profile case, but Lyons never saw proof of such leaks
11 as the NTA always denied leaking any information. One IRS official, however, was
12 specifically aware prior to October 1997 of more than one leak to the Japanese media of
13 confidential tax information; he knew that a transfer pricing examination as well as
14 results of an NTA proposed adjustment had been disclosed in the Japanese media.

15 There were six instances between October 1, 1987 and September 30, 1996 where
16 the Competent Authority investigated the potential disclosure by the NTA of taxpayer
17 information.¹⁷ None of these were from simultaneous examinations, and none resulted in
18 the Competent Authority concluding that the NTA had leaked taxpayer information.
19 Lyons had heard rumors that the Japanese media had a permanent presence in NTA
20 headquarters, but the NTA had denied this to the IRS and insisted that it knew its
21 responsibilities.

22 Following the media reports, the IRS temporarily suspended the exchange of
23 taxpayer information with Japan. The IRS’s internal e-mail announcing this suspension
24 cited as reasons the past instances of the NTA’s improper disclosure of taxpayer
25 information as well as the specific allegations in this particular case. The IRS later lifted
26 this suspension after the NTA took steps aimed at preventing any further disclosures of

27
28 ¹⁷ During the same time period, the IRS disclosed taxpayer information to the
NTA approximately 400,000 times.

1 treaty information.

2 In connection with discovery in this case, thirteen current and former NTA
3 officials involved in the simultaneous examination have stated under oath that they did
4 not personally know the source of the media reports. However, the NTA refused to allow
5 its officials to answer questions regarding the investigation into the source of the leak.

6 Prior to the media reports, FLPJ disclosed its NTA assessments to approximately
7 150 individuals associated with FLPJ as well as to two banks (Asahi and Sanwa).¹⁸ None
8 of these individuals have ever denied under oath being the source of the media reports.
9 Other FLP Group employees, such as AVA's vice president of taxes and Forever Living
10 Products International's controller knew of the simultaneous examination in 1996 but
11 have never been asked if they were a source of the media reports. FLPJ never asked its
12 employees, general managers, or President's Club Members if they were the source of the
13 media reports. Six days after the media reports, Japanese counsel for FLPJ opined in a
14 letter to Plaintiffs' counsel that there was no evidence the NTA leaked the information to
15 the media and Plaintiffs would thus have to ask the NTA whether it was the source.

16 Considering and weighing all of the evidence, the Court finds that the NTA leaked
17 information to the Japanese media concerning the NTA assessments. The NTA was the
18 source for the October 1997 media reports.¹⁹

19
20 ¹⁸ *See supra* section II.C.

21 ¹⁹ This finding rests, in part, upon the expert testimony of Professor Watanabe,
22 who testified how the Japanese media uses certain words and phrases to indicate the
23 source is reliable while not actually naming the source. Reducing Japanese culture, with
24 which the Court is not natively familiar, to a series of simple statements to be considered
25 a trial is a difficult challenge. It appears to the Court that the use of these words, such as
"kankeisha," is vaguely similar to if, for example, a person answered a question while
simultaneously winking one eye. In this example, the context of winking imparts a
nonliteral meaning to an otherwise literal oral statement but this nonliteral meaning is
conveniently deniable.

26 Significantly, the United States offered *no* controverting evidence or expert to
27 rebut Watanabe's testimony, and did not succeed on cross-examination in undermining
28 Watanabe's credibility to any significant extent. Nevertheless, Watanabe's testimony is
not irreproachable, and the Court would not conclude the NTA was the source of the leak
beyond a reasonable doubt. But when combined with the other evidence in the record, the
Court is definitely and firmly convinced by a preponderance of the evidence that the
NTA was the source of the leak.

1 **E. Effects from the Media Reports**

2 The media reports had immediate, negative effects upon FLPJ's reputation and
3 sales. FLPJ held a number of meetings with its distributors to explain its position and
4 show how the payments that were the subject of the media reports were in fact being
5 taxed in the United States. Nevertheless, the media reports tarnished FLPJ's image with
6 its distributors and the public, some of whom no longer wished to do business with a
7 company that they considered to be a tax evader.

8 Plaintiffs' expert, Dr. Steven Schwartz, testified extensively as to the negative
9 effects of the media reports upon FLPJ's sales. The Court need not discuss the details of
10 his otherwise overwhelmingly credible testimony because a necessary step in Dr.
11 Schwartz's damages calculation was to convert lost FLPJ sales into AVA profits by
12 applying AVA's incremental profit margin for sales of aloe vera gel to FLPJ. Rjay Lloyd,
13 who holds a management position with the FLP Group, supplied Dr. Schwartz with a
14 figure of 68% for AVA's incremental profit margin and asked him to assume that it was a
15 proper profit margin.

16 Dr. Schwartz has no knowledge as to whether this 68% figure was correct or
17 reasonable, he did not analyze it, and his expert opinion does not extend to its truth or
18 accuracy. He asked for the data underlying the 68% figure, but never received it from
19 Plaintiffs. In fact, Lloyd declined to give Dr. Schwartz documentation supporting the
20 profit margin figure. AVA's actual incremental profit margin is unknown.

21 However, the media reports had a statistically significant negative effect upon
22 FLPJ's sales beginning in October and November 1997, which negatively affected
23 AVA's sales as well as commissions paid to Maughan and Yamagata. This negative
24 effect lasted until 2003.

25 **F. Reversal of the NTA Assessments**

26 As part of FLPJ's contest of the NTA assessments, it obtained a bilateral transfer
27 pricing study regarding the sale of raw aloe vera gel between AVA and FLPJ. In the
28 study, the competent authorities for the U.S. and Japan ultimately agreed that AVA

1 charged FLPJ the correct market price for raw aloe vera gel. The tax authorities
2 retroactively applied the results of the transfer pricing study to tax years 1991 through
3 1996.

4 The NTA refunded \$100 million to FLPJ. This refund represented a complete
5 victory for FLPJ and a vindication of the position it had taken with respect to the tax
6 issues before the NTA.

7 **III. Analysis & Conclusions of Law**

8 Plaintiffs' only operative claims in this case are those in Count I of their Third
9 Amended Complaint. *Aloe Vera*, 699 F.3d at 1166. The Court has jurisdiction over these
10 claims, as determined by the Court of Appeals' opinion and the statutes cited therein. *See*
11 *id.* In Count I, Plaintiffs allege that the United States is liable under 26 U.S.C. § 7431 for
12 knowingly providing false tax return information of Plaintiffs to the NTA. There are two
13 alleged disclosures at issue. First, Part III of the SEP estimated that there was unreported
14 U.S. income of approximately \$32 million for tax years 1991 and 1992. This is the
15 "Unreported Income Statement." Second, during the first simultaneous examination
16 meeting in August 1996, international examiner Smith stated in a presentation to the
17 NTA that commission payments by AVA to Maughan and Yamagata on sales of aloe
18 vera product to FLPJ remained unchanged over the years while the price of raw aloe vera
19 gel changed. This is the "Commission v. Price Statement."

20 **A. Liability**

21 To establish the United States' liability under 26 U.S.C. § 7431, Plaintiffs must
22 show that the United States disclosed Plaintiffs' return information to the NTA, this
23 return information was false, and the United States knew this return information was
24 false. *See* 26 U.S.C. §§ 7431(a)(1), 6103(a); *Aloe Vera*, 699 F.3d at 1164-65. The Court
25 finds, and the United States does not dispute, that the IRS disclosed the *contents* of the
26 Unreported Income Statement and Commission v. Price Statement to the NTA. In other
27 words, the IRS actually sent Part III of the SEP to the NTA, and Smith actually
28 commented to the NTA that commissions remained the same while prices varied. The

1 issue is whether these statements contained knowingly false return information of
2 Plaintiffs.

3 **1. Return Information**

4 The United States does not dispute that the Unreported Income Statement and
5 Commission v. Price Statement contain return information of the Maughans and AVA,
6 but argues that they do not contain the return information of Yamagata, YHI, or MHI.
7 (Doc. 695 at 5; Doc. 700 at 1-2).

8 **a. Legal Standard**

9 Section 7431 of the Internal Revenue Code provides that the United States is liable
10 for the knowing or negligent disclosure of “any return or return information with respect
11 to a taxpayer in violation of any provision of section 6103.” 26 U.S.C. § 7431(a)(1).
12 Section 6103 provides that “return information” is confidential unless disclosure is
13 statutorily authorized and defines “return information” as including:

14 a taxpayer’s identity, the nature, source, or amount of his
15 income, payments, receipts, deductions, exemptions, credits,
16 assets, liabilities, net worth, tax liability, tax withheld,
17 deficiencies, overassessments, or tax payments, whether the
18 taxpayer’s return was, is being, or will be examined or subject
19 to other investigation or processing, or any other data,
20 received by, recorded by, prepared by, furnished to, or
collected by the Secretary with respect to a return or with
respect to the determination of the existence, or possible
existence, of liability (or the amount thereof) of any person
under this title for any tax, penalty, interest, fine, forfeiture, or
other imposition, or offense[.]

21 26 U.S.C. § 6103(b)(2)(A); *see also* 26 U.S.C. § 7431(f) (“For purposes of this section,
22 the term[] . . . “return information” [has] the respective meaning[] given . . . by section
23 6103(b)”).

24 “Taxpayer information obtained or prepared by the IRS . . . is ‘return information’
25 regardless of the person with respect to whom it was obtained or prepared.” *Aloe Vera*,
26 699 F.3d at 1157 (quoting *Mallas v. United States*, 993 F.2d 1111, 1118 (4th Cir. 1993)).

27 **b. Analysis**

28 The United States argues that the neither the Unreported Income Statement nor the

1 Commission v. Price Statement contained tax return information of Plaintiffs Yamagata,
2 YHI, or MHI because the statements do not suggest that they are such return information
3 and Smith, who authored both statements, did not review the tax returns of Yamagata,
4 YHI, or MHI. (Doc. 695 at 5).

5 But the Unreported Income Statement cannot be read in a vacuum. Although the
6 only entities explicitly listed in the SEP as being under examination were the Maughans,
7 AVA, and related entities Selective Art, Inc. and Forever Living Products International,
8 the purpose of the SEP was to connect this unreported U.S. income to unreported
9 Japanese income. The SEP did so in the context of explaining that Maughan and
10 Yamagata were equal owners of FLPJ and had allegedly used Batrax for the purpose of
11 evading U.S. income taxes. The SEP mentions that Maughan and Yamagata receive a
12 commission on every gallon of aloe vera gel sold by AVA to FLPJ and then asserts that
13 FLPJ is inflating its cost of goods sold by improperly including this commission. The
14 figures in Part III of the SEP for unreported U.S. income exactly equal the sum of the
15 figures for proposed disallowances by Japan of royalty and commission expenses. The
16 SEP identifies commissions to Maughan and Yamagata as the source of increased tax
17 liability for FLPJ. FLPJ is owned by MHI and YHI, which are wholly owned by
18 Maughan and Yamagata, respectively.

19 The Unreported Income Statement contained the return information of Maughan
20 and Yamagata for two reasons. First, because the statement concerning \$32 million of
21 unreported U.S. income directly implied increased tax liability for FLPJ and FLPJ's tax
22 liability was borne by its owners MHI and YHI, which as S corporations in turn placed
23 this liability on Maughan and Yamagata, this statement was data prepared by the IRS
24 with respect to the "determination of the existence, or possible existence, of liability (or
25 the amount thereof)" of tax for Maughan and Yamagata. *See* 26 U.S.C. § 6103(b)(2)(A).
26 Second, and independently, because the statement concerning \$32 million of unreported
27 U.S. income was preceded by the detailed explanation in Part II of the SEP concerning
28 the commissions paid to both Maughan and Yamagata and how these commissions had

1 previously been paid to Batrax for the purpose of evading U.S. taxes, and because the \$32
2 million unreported U.S. income statement did not specify or limit to which taxpayer it
3 applied, the statement implied that Maughan and Yamagata had unreported commission
4 income taxable by the U.S. in the amount of \$32 million.²⁰ Such an implication would be
5 the deficiency of a taxpayer as well as data prepared by the IRS with respect to the
6 “determination of the existence, or possible existence, of liability” of tax for Maughan
7 and Yamagata. Thus, the Unreported Income Statement contains return information of
8 AVA, the Maughans and Yamagata.²¹

9 The Commission v. Price Statement also contained the return information of
10 Maughan and Yamagata. The statement and its context suggested that because the
11 commissions to Maughan and Yamagata did not change as the cost to FLPJ of aloe vera
12 gel changed, either the amount of the commissions or their tax treatment as deductible
13 commissions was improper. As with the Unreported Income Statement, because the
14 commissions deducted by AVA were also included in FLPJ’s cost of goods sold, and
15 FLPJ’s tax liability passed through to Maughan and Yamagata, the Commission v. Price
16 Statement constituted data prepared by the IRS with respect to “the determination of the
17 existence, or possible existence, of liability (or the amount thereof)” for tax for Maughan
18 and Yamagata. *See* 26 U.S.C. § 6103(b)(2)(A).

19
20 ²⁰ The United States argues that Smith testified that “in making the \$32 million
21 unreported income estimate, he had not gotten as far as trying to attribute that amount to
22 Maughan or Yamagata.” (Doc. 695 at 5). But it is precisely Smith’s failure to limit the
23 estimate in the SEP to only Maughan that defeats the United States’ argument. The
explicit and implicit assertions contained within the Unreported Income Statement clearly
encompass both Maughan and Yamagata.

24 Similarly, the fact that Smith had not reviewed Yamagata’s returns is irrelevant
25 because Smith’s preparatory work (or lack thereof) before drafting the Unreported
Income Statement does not bear on a determination of what the Unreported Income
Statement actually stated and disclosed.

26 ²¹ The Court does not conclude that the Unreported Income Statement contains
27 return information of MHI and YHI because as S corporations, their tax liabilities passed
28 through to Maughan and Yamagata, respectively. The Court relies on this characteristic
of S corporations to conclude that tax liabilities to FLPJ are liabilities of Maughan and
Yamagata; it would be incongruous to conclude that these same pass-through entities also
have independent return information when they have no independent tax liability.

1 The United States makes two further arguments. First, it argues that because the
2 amount of the commissions paid by AVA to Maughan and Yamagata and the price
3 charged by AVA to FLPJ for aloe vera gel “is readily derived from AVA’s books,” it
4 cannot be the return information of any other person. (Doc. 695 at 5). The Court of
5 Appeals has held in this case that the source of return information is irrelevant to
6 determining whether it is protected under 26 U.S.C. § 6103. *See Aloe Vera*, 699 F.3d at
7 1157. That return information of Maughan and Yamagata could be gleaned from AVA’s
8 books does not negate the plain language of the statute. To hold to the contrary would
9 eviscerate the protections of section 6103. For example, the IRS could inspect the books
10 of a partnership to ascertain the income received by its partners and then make
11 unauthorized disclosures of the partners’ business income without such disclosure
12 constituting the partners’ return information, simply because the information was readily
13 obtainable from the partnership records. This result would undermine the protections
14 Congress intended to provide in section 6103.

15 Finally, the United States argues that *Mallas v. United States*, 993 F.2d 1111 (4th
16 Cir. 1993), upon which the Court of Appeals relied in the instant case, stands for the
17 proposition that “only the person with respect to whose liability the information was
18 collected can sue for an unauthorized disclosure of that information.” (Doc. 700 at 1).
19 The United States misreads *Mallas*. Although the court in that case noted in *dicta* that
20 disclosures of the appellants’ financing scheme contained information “collected by the
21 Secretary” under section 6103 because the details of the scheme were derived from the
22 IRS’s criminal investigation of the appellants, the court did not limit section 6103’s broad
23 definition of “return information” to only information collected from the taxpayer. *See*
24 993 F.2d at 1118-19. The United States’ interpretation of *Mallas* would obliterate the
25 majority of the numerous disjunctive conditions qualifying as return information, in
26 contravention of the plain language of the statute.

27 Accordingly, both the Unreported Income Statement and the Commission v. Price
28 Statement contained return information within the meaning of section 6103 of AVA, the

1 Maughans, and Yamagata.

2 **2. Knowingly False Return Information**

3 The United States argues that the Unreported Income Statement and the
4 Commission v. Price Statement were not false statements. (Doc. 695 at 2-3). With respect
5 to the Unreported Income Statement, the United States contends that it was neither false
6 nor knowingly false because as a good-faith estimate of *possible* unreported income, an
7 estimate cannot be false and Smith did not know the estimate could not be true. (*Id.* at 3).

8 The Court finds Smith to be a highly credible witness. Smith testified that he
9 suspected the FLP Group could have unknown aloe vera farms that used a Batrax-like
10 entity to avoid reporting U.S. income. Smith also testified such unreported income might
11 not exist, and he could not provide a numeric estimate of such income because its
12 existence and extent were completely unknown. Smith testified that his IRS superiors
13 essentially forced him to include numbers in the SEP, over his protests. Smith testified
14 that he used aloe vera sales to generate an estimate of unknown aloe vera farms and
15 unknown entities, and that he did not base this estimate upon actual calculations of
16 commission income paid to Maughan and Yamagata. Smith testified he knew of no actual
17 unreported income at the time he drafted his estimate, he believed the amount “couldn’t
18 be quantified,” and he knew his explanation that the estimate was based upon aloe vera
19 gel sales was inaccurate. Smith testified that his estimate was a *potential* estimate of
20 unreported income but he did not believe that Maughan and Yamagata actually had \$32
21 million of unreported income.

22 Had Smith’s estimate been \$32 billion instead of \$32 million, it would have also
23 been a *potential* estimate of unreported income. \$50 million, \$1, and \$234.3 million
24 would also have been *potential* estimates of unreported income because any unknown
25 unreported income *could* have existed in these amounts. But the fact that a number is
26 described as an estimate does not mean that it can never be objectively false. Although
27 the nature of an estimate is such that the estimate does not guarantee that the true value of
28 the thing being estimated will equal that predicted in the estimate, the estimate does carry

1 an implied assertion that its author knows facts that justify the selection of the particular
2 value chosen as the estimate. Blind guesses are not good faith estimates.

3 The Court of Appeals has previously rejected the United States' argument on this
4 point, holding that "even an estimate can be objectively false if, for example, the
5 communicator knows it *cannot* be true." *Aloe Vera*, 699 F.3d at 1164. "[A]n opinion or
6 estimate carries with it an 'implied assertion, not only that the speaker knows no facts
7 which would preclude such an opinion, but that he does know facts which justify it.'" *Id.*
8 (quoting *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 792 (4th Cir.
9 1999)). The Court of Appeals also held that "[m]ore importantly, the question in this case
10 is not the amount of the estimate, but whether Taxpayers had accurately reported the
11 information."

12 The IRS had no basis whatsoever for its estimate that there was \$32 million of
13 unreported income. The uncontroverted testimony of Smith, the former IRS international
14 examiner, shows that this figure was an unfounded guess for which Smith knew there
15 was no basis. Moreover, Smith knew the figure could not be true because he knew he had
16 no information to justify the selection of \$32 million as the estimate versus any other
17 dollar amount. The \$32,116,000 estimate for tax years 1991 and 1992 contains at least
18 five significant digits (32116), carrying with it an implied assertion that the IRS knew
19 facts enabling it to compute the estimate with this degree of precision. Such facts did not
20 exist, and the IRS knew they did not exist. Additionally, the IRS knew of no inaccuracies
21 in Plaintiffs' tax returns. The Unreported Income Statement was false and the United
22 States knew it was false.²²

23
24 ²² The United States argues that Plaintiffs fail to show that the \$32 million
25 estimate of unreported U.S. income was connected to unreported royalties and
26 commissions of Maughan and Yamagata. (Doc. 700 at 2). First, the fact that the amounts
27 for tax years 1991 and 1992 of unreported U.S. income equal the amounts to be
28 disallowed by Japan for royalty and commission expenses undermines the United States'
argument. Second, even if this equality were not the case and accepting the United States'
argument as true, Smith's testimony clearly shows that the United States had no basis
whatsoever for the \$32 million figure—be it from royalties, commissions, or any other
payments of money. In fact, the evidence shows that the IRS purported the figure to be
based upon the sales of raw aloe vera gel.

1 With respect to the Commission v. Price Statement, there is no evidence
2 suggesting that Smith knew at the time of making the statement that it was false. The
3 only relevant evidence bearing on Smith's knowledge concerning falsity is Smith's own
4 testimony. The Court finds Smith to be a highly credible witness who, throughout his
5 testimony, freely admitted to shortcomings in his memory due to the age of this case.
6 Smith admits that the Commission v. Price Statement is false. He does not remember
7 making the statement, but clearly and credibly testified that he did not intend to make
8 such a false statement. In the absence of any other evidence bearing on Smith's intent at
9 the time of making the statement, it appears that Smith's statement was at most negligent,
10 but not intentional. The United States did not know the Commission v. Price Statement to
11 be false at the time Smith uttered it.²³

12 **3. Conclusion**

13 For the foregoing reasons, the Court concludes that with respect to the Unreported
14 Income Statement the United States disclosed to the NTA the return information of each
15 of Plaintiffs AVA, the Maughans, and Yamagata; this return information was false; and
16 the United States knew this return information to be false at the time of its disclosure.
17 The knowing disclosure of false return information is unauthorized by the tax treaty with
18 Japan. *Aloe Vera*, 699 F.3d at 1163-64. Thus, the United States is liable to Plaintiffs
19 AVA, the Maughans, and Yamagata, under 26 U.S.C. § 7431(a)(1) for the unauthorized
20 disclosure of the Unreported Income Statement.

21 With respect to the Commission v. Price Statement, Plaintiffs cannot show that the
22 United States knew the statement to be false, and therefore the United States is not liable
23 to Plaintiffs for the disclosure of the Commission v. Price Statement.

24 **B. Damages**

25 Section 7431(c) provides that a taxpayer whose return information was the subject
26 of unauthorized disclosure by the IRS is entitled to either statutory damages of \$1,000 per
27

28 ²³ Because the United States did not know the Commission v. Price Statement was false, the Court does not decide whether the statement was actually false.

1 unauthorized disclosure or actual and punitive damages. 26 U.S.C. § 7431(c).

2 **1. Actual and Punitive Damages**

3 Plaintiffs ask the Court to award \$52 million in actual damages, consisting of \$47
4 million in economic damages resulting from the media reports and \$5 million in
5 attorneys' fees incurred to defeat the NTA assessments. Section 7431 provides that a
6 plaintiff is entitled to "actual damages sustained by the plaintiff as a result of such
7 unauthorized inspection or disclosure" of return information. 26 U.S.C. §
8 7431(c)(1)(B)(i). Establishing actual damages under section 7431(c) requires Plaintiffs to
9 prove both actual and proximate causation. *See Nat'l Org. for Marriage v. United States*,
10 24 F. Supp. 3d 518, 529 (E.D. Va. 2014) (citing *Jones v. United States*, 9 F. Supp. 2d
11 1119, 1137 (D. Neb. 1998)).

12 Plaintiffs fail to prove that the Unreported Income Statement caused the NTA to
13 enter into the simultaneous examination. Actual causation is factual causation and
14 requires a plaintiff to "prove that 'but for' the wrongful act, the harm would not have
15 occurred." *Id.* (quoting *Jones*, 9 F. Supp. 2d at 1137). The SEP contained numerous
16 detailed statements and allegations concerning Plaintiffs' business structure, income
17 sources, and tax liabilities. If the Unreported Income Statement had not been made and
18 Smith had instead left in his original values of "unknown" for U.S. unreported income
19 and potential additional tax to Japan, the SEP still contained its provocative allegations
20 that Maughan and Yamagata were hiding income from the United States and possibly
21 Japan as well as hiding dividends as "commissions" in the cost of goods sold to avoid
22 Japanese withholding tax. These allegations were a sufficient basis for Japan to enter into
23 the simultaneous examination.

24 Plaintiffs point to the NTA's correction notices as evidence of causation, arguing
25 that these notices adopted the "substance over form" recharacterization suggested in Part
26 III of the SEP. (Doc. 696 at 8-9). But even if the NTA's recharacterization of FLPJ's cost
27 of goods sold as nondeductible director bonuses was a direct result of the SEP (and it
28 seems likely this is true), this demonstrates causation only with respect to the other

1 statements in the SEP concerning commission income to Maughan and Yamagata. None
2 of the NTA correction notices cite the \$32 million Unreported Income Statement as a
3 basis for the NTA's assessment decision.

4 Plaintiffs contend that because the IRS previously sent a letter to the NTA
5 discussing many of the same issues later included in the SEP, this letter did not contain
6 the Unreported Income Statement, and the NTA did not act on this letter, this tends to
7 show that the addition of the Unreported Income Statement to the SEP was the cause of
8 Japan's entrance into the simultaneous examination. (*Id.* at 9). This earlier letter outlined
9 the ownership of FLPJ and Batrax, alleged that FLPJ was including commissions to
10 Maughan and Yamagata in its cost of goods sold as a way to avoid withholding taxes and
11 to reduce taxable income by overstating cost of goods sold, and questioned Yamagata's
12 residency. The letter did not, however, contain the Unreported Income Statement or any
13 other figures concerning potential additional tax liability. The letter requested extensive
14 information from the NTA on topics involving Batrax.²⁴

15 Plaintiffs point to this letter and the NTA's non-response as evidence that the
16 Unreported Income Statement caused the NTA to enter into the simultaneous
17 examination. (Doc. 696 at 9). It is plausible that had the NTA read that the unreported
18 U.S. income was unknown instead of \$32 million, it would not have chosen to enter into
19 the simultaneous examination. Certainly large amounts of unreported taxes can be
20 motivation to engage in an audit. But it is also plausible that the NTA was motivated to
21 enter into the simultaneous examination as a result of the details of Maughan and
22 Yamagata's income structure (i.e. Batrax, deferred taxes, and hidden commissions) and
23 the Unreported Income Statement, as a mere estimate, was not itself sufficient
24 motivation. In the absence of evidence, the Court can only speculate as to the NTA's
25 motives.²⁵

26
27 ²⁴ The Court finds those facts contained in these three sentences but has not also
28 included them in the findings of fact section because the Court cites this 1995 request
only to address Plaintiffs' argument on this issue.

²⁵ Plaintiffs argue that the Unreported Income Statement caused the NTA to

1 The issue is one of the burden of proof, and Plaintiffs bear the burden of proving
2 causation by a preponderance of the evidence. Plaintiffs attempt to shift this burden to the
3 United States by citing *Liriano v. Hobart Corporation*, 170 F.3d 264 (2d Cir. 1999),
4 which held that New York common law created a rebuttable presumption of actual
5 causation when a defendant’s negligent act “is deemed wrongful precisely because it has
6 a strong propensity to cause the type of injury that ensued.” 170 F.3d at 271. *Liriano*
7 concerns a duty to warn under common law and is inapposite here. Section 7431 is a
8 waiver of sovereign immunity that must be “construed strictly in favor of the sovereign”
9 and not enlarged beyond its language. *Siddiqui v. United States*, 359 F.3d 1200, 1204 (9th
10 Cir. 2004).

11 Plaintiffs must show that it is more probably true than false that the NTA entered
12 into the simultaneous examination because of the Unreported Income Statement. This
13 they simply cannot do.²⁶ Accordingly, Plaintiffs have failed to meet their burden of
14 proving they incurred actual damages as a result of the Unreported Income Statement.²⁷
15 Because section 7431 “precludes punitive damages against the United States absent proof
16 of actual damages,” *Siddiqui*, 359 F.3d at 1204, Plaintiffs’ claim for punitive damages
17 also fails.

18 **2. Statutory Damages**

19 Plaintiffs are entitled to statutory damages in the amount of \$1,000 for each
20 unauthorized disclosure of return information for which the United States is liable. *See* 26

21
22 conclude that the proposed simultaneous examination was a case of “vicious” tax
23 evasion. (Doc. 701 at 3). As evidence, they point to the fact that two of the NTA officials
24 at the simultaneous examination meetings had job duties that included working on
25 “vicious tax evasion matters.” This evidence does not support Plaintiffs’ argument.
26 Moreover, even if the Unreported Income Statement had caused the NTA to conclude
27 that there was “vicious” tax evasion, it does not automatically follow that the Unreported
28 Income Statement caused the NTA to enter into the simultaneous examination.

²⁶ The Court has considered but not discussed two of Plaintiffs’ arguments in
response to the United States’ post-trial brief because the Court instead rejects the United
States’ arguments on this point. *See* (Doc. 701 at 4) (factual accuracy of the NTA
assessments and the NTA’s “historical practice”).

²⁷ Because Plaintiffs fail to show actual causation, the Court need not address
proximate causation.

1 U.S.C. § 7431(c)(1)(A). In this case, the IRS made a single unauthorized disclosure, but
2 that disclosure contained the return information of three persons/entities. Accordingly,
3 AVA, the Maughans, and Yamagata are each entitled to \$1,000 in statutory damages.²⁸

4 **3. Costs**

5 Under section 7431, Plaintiffs are entitled to the “costs of the action.” 26 U.S.C. §
6 7431(c)(2). Accordingly, Plaintiffs may file a bill of costs with the Clerk of the Court in
7 accordance with Local Rule of Civil Procedure (“Local Rule”) 54.1.

8 **4. Attorneys’ Fees**

9 Plaintiffs may be entitled to an award of reasonable attorneys’ fees against the
10 United States under section 7431(c)(3). Ordinarily, the Court permits a party seeking fees
11 to file, after entry of final judgment on the merits, a motion for attorneys’ fees that
12 discusses the movant’s eligibility for fees, entitlement to fees under relevant legal
13 authority, and reasonableness of the requested fees. *See* LRCiv 54.2(c). Any fee request
14 by Plaintiffs will involve the compilation of voluminous billing records representing the
15 nearly sixteen years of litigation in this case. Section 7431(c)(3) entitles a party to an
16 award of fees against the United States in certain circumstances, but requires the Court to
17 make certain determinations involving other sections of the Internal Revenue Code (such
18 as whether Plaintiffs are the “prevailing party”). The Court believes it would be
19 inefficient to require Plaintiffs to expend significant resources to file a motion for
20 attorneys’ fees when the entitlement to a fee award is presently unclear and such a motion
21 could be denied.

22 Therefore, in the interests of efficiency, the Court will bifurcate any request for
23 attorneys’ fees. Plaintiffs may move within fourteen days from the date of this Findings
24 of Fact and Conclusions of Law to establish legal entitlement to a fee award under
25 section 7431(c)(3). The sole issue in such motion shall be whether Plaintiffs are legally
26 entitled to an award of “reasonable attorneys fees” as that phrase appears in section

27 ²⁸ The Court assumes Rex and Ruth Maughan are not each entitled to a separate
28 award of statutory damages because at all relevant times their tax liability was jointly
computed.

1 7431(c)(3); the motion must not address the amount of reasonable attorneys' fees. The
2 United States' response and any reply by Plaintiffs shall be within the time limits
3 specified in Local Rule 7.2.

4 The Court will then rule on Plaintiffs' motion and if it grants the motion, will at
5 that time permit Plaintiffs to file a motion for an award of reasonable attorneys' fees. This
6 second motion, response, and reply will comply with Local Rule 54.2(c) in all regards.

7 **IV. Conclusion**

8 For the foregoing reasons,

9 **IT IS ORDERED** that the Clerk of the Court shall enter judgment for Rex and
10 Ruth Maughan (jointly) and against the United States in the amount of \$1,000 on the
11 Maughans' claim for unauthorized disclosure under 26 U.S.C. § 7431(a).

12 **IT IS FURTHER ORDERED** that the Clerk of the Court shall enter judgment
13 for Aloe Vera of America, Inc. and against the United States in the amount of \$1,000 on
14 AVA's claim for unauthorized disclosure under 26 U.S.C. § 7431(a).

15 **IT IS FURTHER ORDERED** that the Clerk of the Court shall enter judgment
16 for Gene Yamagata and against the United States in the amount of \$1,000 on Yamagata's
17 claim for unauthorized disclosure under 26 U.S.C. § 7431(a).

18 **IT IS FURTHER ORDERED** that the Clerk of the Court shall enter judgment
19 for the United States and against Maughan Holdings, Incorporated on MHI's claim for
20 unauthorized disclosure under 26 U.S.C. § 7431(a).

21 **IT IS FURTHER ORDERED** that the Clerk of the Court shall enter judgment
22 for the United States and against Yamagata Holdings, Incorporated on YHI's claim for
23 unauthorized disclosure under 26 U.S.C. § 7431(a).

24 **IT IS FURTHER ORDERED** that Plaintiffs may, within fourteen days from the
25 date of this Findings of Fact and Conclusions of Law, file a motion for a ruling that they
26 are entitled to an award of reasonable attorneys' fees. Plaintiffs' motion must comply
27 with the restrictions specified in this Findings of Fact and Conclusions of Law. Any
28 response and reply are due within the time limits prescribed in Local Rule of Civil

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Procedure 7.2.

Dated this 10th day of February, 2015.



James A. Teilborg
Senior United States District Judge