

Appeal of Charles I., and Phyllis R. Owen

assessment of a fraud penalty in the amount of \$1,334.00 and a penalty for failure to file a return upon notice and demand in the amount of \$667.00 for the year 1967, and on the protest of Charles I., and Phyllis R. Owen against proposed assessments of fraud penalties in the amounts of \$2,346.50 and \$3,406.50 for the years 1968 and 1969, respectively.

During the years under appeal, Charles L. Owen (hereafter appellant) was employed as the personal manager of a well-known country and western singer. That employment accounted for the major portion of appellant's income for the years in issue. In addition, appellant derived income from his business interests in music publishing and recording enterprises.

Sometime in 1969, respondent received an information form from Capitol Records Company which reported the payment of royalties to appellant. Respondent's investigation into the matter revealed that appellant had not filed California personal income tax returns for the years 1967 and 1968. On September-11, 1969, respondent sent to appellant a request for information concerning his failure to file a return for 1967. A similar inquiry was sent to appellant on October 10, 1969. Appellant did not respond to the inquiries .

Thereafter, respondent's investigator personally contacted appellant and questioned him concerning the apparent delinquency of the returns. At that time appellant admitted that he had earned substantial income during the years in issue and that he had failed to file timely returns for those years. Appellant explained that his bookkeeper, upon whom he had previously relied to file his tax returns, had retired. Appellant also stated that although he was currently preparing the delinquent returns, his completion of that task was delayed because his employment required extensive travel away from home.

Subsequently, on June 30, 1971, appellant filed California personal income tax returns, separately for 1967, and jointly with his wife, Phyllis R. Owen, for 1968 and 1969. Appellant paid the taxes and interest due for each of those years, as well as a 25 percent penalty for failure to file a timely return

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for each year, and a 10 percent penalty for failure to pay estimated tax for 1968 and 1969. (Rev. & Tax. Code, §§ 18681, 18685.01.) Also, on August 19, 1971, appellant entered a plea of nolo contendere to a charge of criminal tax evasion brought pursuant to section 19406 of the Revenue and Taxation Code.

Respondent also assessed a 50 percent civil fraud penalty against appellant for each of the years 1967, 1968; and 1969 pursuant to section 18685 of the Revenue and Taxation Code, and a 25 percent penalty for failure to file a 1967 tax return upon notice and demand pursuant to section 18682 of the Revenue and Taxation Code. The record on appeal indicates that appellant does not challenge the propriety of the section 18682 penalty for 1967. Therefore, the sole issue presented by this appeal is whether respondent's action in assessing the civil fraud penalties against appellant for the years 1967, 1968, and 1969 should be sustained. Pursuant to the request of appellant, acquiesced in by respondent, the appeal was submitted for decision on the basis of memoranda filed therein and without oral hearing before this board.

The burden of proving fraud is upon respondent, and it must be established by clear and convincing evidence. (Valetti v. Commissioner, 260 F. 2d 185, 188; Appeal of George W. Fairchild, Cal. St. Bd. of Equal. , Oct. 27, 1971.) Fraud implies bad faith, intentional wrongdoing, and a sinister motive; the taxpayer must have the specific intent to evade a tax believed to be owing. (Jones v. Commissioner, 259 F. 2d 300, 303; Powell v. Granquist, 252 F. 2d 56, 60.) Although fraud may be established by circumstantial evidence (Powell v. Granquist, supra at 61), it is never presumed, and a fraud penalty will not be sustained upon circumstances which, at most, create only suspicion. (Jones-v. Commissioner, supra at 303.)

Respondent contends that the following factors constitute clear and convincing evidence that appellant, in failing to file timely returns for the years in issue, deliberately intended to evade tax: (1) appellant allegedly made false and misleading statements to respondent's investigator; (2) appellant kept poor financial records for-the years in issue; and (3) the fine imposed by the court **upon** appellant's conviction of criminal tax evasion was **substantial in** amount.

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The record on appeal contains no evidence of false and misleading statements made by appellant to respondent's investigator. To the contrary, the record indicates that appellant was cooperative throughout the investigation. During the investigative interview appellant stated that he was in the process of preparing his delinquent returns and that his bookkeeper had retired in 1966. The bookkeeper apparently did not retire until 1967. Respondent contends that the erroneous statement and the fact that appellant did not file the returns until after he had been advised of respondent's investigation indicate that he was evasive in supplying information concerning his activities. However, we are unable to draw from these factors alone the inference that appellant deliberately intended to mislead respondent.

Respondent alleges that appellant maintained poor records of income for the years in issue in a deliberate attempt to evade tax. However, while appellant may have kept disorganized records of his expenses, the record on appeal does not indicate that he maintained poor records of his income. The major portion of appellant's income for the years in issue was calculated as a fixed percentage of his employer's income. Therefore, respondent could easily have ascertained and verified appellant's income from third party sources. Furthermore, when appellant finally filed his delinquent returns, respondent accepted as correct the statements of income contained therein. Respondent has presented no evidence which might indicate that appellant attempted to conceal his sources of income, or that he deliberately maintained disorganized financial records for that purpose.

With respect to appellant's conviction of criminal tax evasion based on a plea of nolo contendere, we may consider that factor only as part of the general background of the appeal. (See Evid. Code, § 1300; Pen. Code, §§1016; see also Stanley S. Hershey, T. C. Memo. , Nov. 23, 1962.) The fact that appellant paid a substantial fine in connection with the criminal conviction has no bearing upon the civil fraud issue presented by this appeal.

Consequently, the only significant factor remaining which might establish that appellant fraudulently intended to evade tax is the fact that he failed to file timely returns over a three year period. While this factor may raise some suspicion as to the existence of fraud, it is well established that the mere

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failure of a taxpayer to file timely returns, without more, is not sufficient to sustain a conclusive finding of fraud. (Cirillo v. Commissioner, 314 F. 2d 478, 482; Jones v. Commissioner, supra at 303; Appeal of Matthew F. McGillicuddy, Cal. St. Bd. of Equal. , July 31, 1973; Appeal of George W. Fairchild, supra.) Furthermore, as we have previously indicated, appellant has already paid substantial penalties in connection with his failure to file timely returns for the years in issue. The same acts which permit respondent to invoke those penalties will not, standing alone, be sufficient to justify a penalty for fraud. (See Appeal of George W. Fairchild, supra.)

Our review of the record on appeal compels the conclusion that respondent has not met its burden of proving fraud by clear and convincing evidence. ^{1/} Accordingly, we must reverse respondent's action with respect to the assessment of fraud penalties for the years 1967, 1968, and 1969.

^{1/} In its brief for this appeal, respondent expressed uncertainty with respect to the precise position of this board regarding the imposition of the civil fraud penalty. Unfortunately, we cannot provide respondent with a formula by which fraud may be established in every case. Any attempt to do so would "open the door to calculated evasion of the terms used and quibbling about their precise import. " (10 Mertens, Law of Federal Income Taxation § 55.10.) We do emphasize, however, that in order to carry its burden of proving fraud, respondent must establish the alleged facts with clear and convincing evidence. It is not sufficient for respondent to rely solely on alleged facts or conclusion set forth on brief (See Appeal of Matthew F. McGillicuddy, Cal. St. Bd. of Equal. , July 31, 1973) or on conclusions of fraud contained within a federal audit report. (See Appeal of M. Hunter and Martha J. Brown, Cal. St. Bd. of Equal., Oct. 7, 1974.)

