



Appeal of Emery I. and Ingrid M. Erdy

of section 18685 of the Revenue and Taxation Code no liability should attach to Ingrid M. Erdy.

Appellant and his wife have been residents of California since 1963. Appellant was employed as an automobile salesman until November 1969. During the latter part of 1969 and all of 1970 appellant was employed as a licensed real estate salesman for Boise Cascade in Palo Alto. Appellant filed a delinquent return for 1965 and a timely return for 1966. However, respondent's records indicated that appellant failed to file any returns for the four years on appeal. Consequently, respondent's Special Investigation Section was assigned to investigate the matter. On four separate occasions respondent wrote to appellant concerning his failure to file returns. No response was ever received. In addition, respondent requested an appointment with appellant by letters dated June 11, and July 27, 1971. Again appellant failed to respond to these letters. Finally, on August 16, 1971, respondent's representatives went to appellant's place of employment where they personally contacted appellant. A conference was arranged for August 18, 1971.

**During the conference, appellant stated that he had filed state income tax returns for all of the years 1963 through 1970. He stated that all returns were timely filed with the exception of the 1970 return which he claimed was filed in May 1971. Appellant produced unsigned copies of state income tax returns for 1967 and 1968. He stated that his returns for 1969 and 1970 had been prepared by a Mr. Szabo who was then in Hungary. Appellant claimed to have filed these returns and agreed to obtain copies from Mr. Szabo. Appellant also promised to produce records of his expenses and deductions for all years in issue by September 10, 1971. However, appellant failed to produce either the return copies or the promised information.**

During the conference, appellant also stated that both his state and federal returns for 1967 and 1968 had been prepared by Mr. John Grennan who operates

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a bookkeeping and tax service. Mr. Grennan confirmed the fact that he had prepared appellant's returns for 1967 and 1968, and that he also had prepared appellant's 1966 returns. He stated that he gave the returns to appellant for signature and for filing with the Franchise Tax Board and the Internal Revenue Service.

In response to questions concerning the locations of his bank accounts, appellant stated that he had accounts located at the Bank of America branches in Danville and in Lafayette, the Central Valley Bank in Concord, and in the Wells Fargo Bank in Burlingame. However, subsequent investigation revealed an additional account which appellant had not disclosed during the investigation. This additional account was a checking account located at the Bank of California in Danville. The account was maintained from February 6 to December 11, 1970. During this period a total in excess of \$132,000 was deposited in the account.

On January 11, 1972, a complaint was filed in the Contra Costa County Superior Court charging appellant with violating section 19406 of the Revenue and Taxation Code which provides that it is a felony for any person to willfully fail to file any return with intent to evade any tax imposed by the Personal Income Tax Law. Appellant entered a plea of nolo contendere and was convicted of violating section 19406 on June 16, 1972.

On July 11, 1972, one month after his conviction, appellant filed returns for 1969 and 1970. In March 1973, he signed the copies of the 1967 and 1968 returns which had been submitted previously. These returns were adjusted by respondent to conform to certain federal adjustments for the same years.

Respondent subsequently issued notices of proposed assessment imposing certain penalties, including the 50 percent fraud penalty. Appellant protested the assessments. As a result of the protest appellant agreed to the imposition of certain penalties and respondent agreed to withdraw other penalties. The

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only unagreed item was the fraud penalty. Thus, the sole issue for determination is whether-the fraud penalty was properly applied.

Appellant has not denied the facts relied on by respondent to establish the existence of fraud by clear and convincing evidence for the years in issue. Accordingly, we find that appellant's failure to file state personal income tax returns for the years in issue was willful and with the specific intent to evade taxes known to be owing. (See generally Stoltzfus v. United States, 398 F.2d 1002 (3rd Cir. 1968); Powell v. Granquist, 252 F.2d 56 (9th Cir. 1958); Richard E. Gorman, T.C. Memo., Oct. 10, 1972.)

The thrust of appellant's argument is that the 50 percent fraud penalty was improperly computed. Specifically, appellant asserts that the fraud penalty provided for in section 18685 of the Revenue and Taxation Code<sup>1/</sup> can be applied only if part of the assessed deficiency is due to fraud. In the instant appeal, the amount of tax shown on appellant's late returns which were filed prior to respondent's proposed assessment has never been assessed as a deficiency. Since no part of the nominal deficiency assessed to reflect federal adjustments to appellant's returns resulted

1/ Section 18685 of the Revenue and Taxation Code states:

If any part of any deficiency is due to fraud with intent to evade tax, 50 percent of the total amount of the deficiency, in addition to the deficiency and other penalties provided in this article, shall be assessed, collected, and paid in the same manner as if it were a deficiency. In the case of a joint return, this section shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

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from fraud, appellant concludes that the fraud penalties which were computed on the entire underpayment of the tax, not merely on the deficiencies, for each of the appeal years cannot stand.

Appellant's position is based upon the fact that section 18685 of the Revenue and Taxation Code was patterned after section 293(b) of the Internal Revenue Code of 1939. As appellant correctly indicates, the word "deficiency" in the 1939 code was changed to "underpayments" in the 1954 Code. California did not adopt this change.

The same argument has been advanced before the United States Tax Court where it was resolved adversely to the taxpayer. For example, in Charles F. Bennett, 30 T.C. 114 (1958), the court answered the argument in the following manner:

If petitioners had not thereafter filed the so-called delinquent and amended returns, there could be no question that the 50 per cent additions for fraud pursuant to section 293 (b) of the 1939 Code would properly be measured by the entire amount of tax originally due. Cf. Fred N. Acker, 26 T.C. 107; A. Raymond Jones, 25 T.C. 1100; Arthur M. Slavin, 43 B.T.A. 1100, affirmed 129 F.2d 325 (C.A. 8); Ollie V. Kessler, 39 B.T.A. 646; Pincus Brecher, 27 B.T.A. 1108. May such additions for fraud be erased or diminished merely because the taxpayers filed so-called delinquent returns, long after the due dates of the returns for the years involved, and long after their liability for taxes and additions for fraud had accrued? We think the answer must be in the negative.

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Certainly, if instead of fraudulently failing to file returns petitioners had in the first instance filed timely but false returns, the additions for fraud would persist notwithstanding the later filing of amended non-fraudulent returns. Such has been firmly established. (George M. Still, Inc., 19 T.C. 1072, affirmed 218 F.2d 639 (C.A. 2); Herbert Eck, 16 T.C. 511, affirmed 202 F.2d 750 (C.A. 2), certiorari denied 346 U.S. 822; Harry Sherin, 13 T.C. 221; Aaron Hirschman, 12 T.C. 1223; Maitland A. Wilson, 7 T.C. 395; Thomas J. McLaughlin, 29 B.T.A. 247. Cf. P. C. Petterson, 19 T.C. 486; Nick v. Dunlap, 185 F.2d 674 (C.A. 5). In George M. Still, Inc., supra, we said (19 T.C. at 1077):

"Any other result would make sport of the so-called fraud penalty. A taxpayer who had filed a fraudulent return would merely take his chances that the fraud would not be investigated or discovered, and then, if an investigation were made, would simply pay the tax which he owed anyhow and thereby nullify the fraud penalty. We think Congress has provided no such magic formula to avoid the civil consequences of fraud...."

The same reasoning is equally applicable where the fraud is associated with a deliberate failure to file a return in the first instance. And the record in this case strongly suggests, if it does not in fact establish, that the so-called delinquent returns were filed by petitioners only after they had reason to believe that the Treasury was about to investigate their affairs. Surely Congress did not intend to provide the 'magic formula'

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to avoid the civil consequences of fraud where no return at all had originally been filed while at the same time withholding it from those who had originally filed a false return. We think a fair and reasonable construction of the revenue laws requires that both situations be treated alike. (30 T.C. at 122-123.)

The same argument was again advanced before the Tax Court in Herbert C. Broyhill, T.C. Memo., Feb. 14, 1968, where the years in issue involved the Internal Revenue Code of 1939 and the Internal Revenue Code of 1954. In deciding the question against the taxpayer the Broyhill court stated:

In his pleadings the petitioner asserts error in the action of the respondent in basing the 50 percent addition to tax for fraud on the full amount of the tax liability determined by him to be due, rather than upon the deficiency stated in the notice of deficiency computed by subtracting the tax liability shown on the delinquent returns from the full tax liabilities as determined by the respondent. Such action was not erroneous. It is well established that where no returns, except delinquent returns, are filed the deficiency or underpayment for purposes of section 293(b) of the 1939 Code and section 6653(b) of the 1954 Code is the correct tax due, rather than the excess of the correct tax over the tax shown on the delinquent returns. Middleton v. Commissioner, (C.A. 5) 200 F.2d 94 [42 AFTR 9201, affirms a Memorandum Opinion of this Court; Charles F. Bennett, supra; Maitland A. Wilson, 7 T.C. 395; Cirillo v. Commissioner, supra; and section 6653(c) (1) of the 1954 Code, supra. (T.C. Memo., Feb. 14, 1968 at 68-144.)

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In view of the authority cited above, we conclude that appellant's argument is without merit and that respondent properly applied the 50 percent fraud penalty.

Appellant also argues that it is inappropriate to assert both a 25 percent late filing penalty and the 50 percent fraud penalty. In support of his position appellant points out that in accordance with the present structure of the Internal Revenue Code of 1954 the late filing penalty and the fraud penalty are mutually exclusive; However, as noted above, section 186.85 of the Revenue and Taxation Code, which contains the fraud penalty provisions, was patterned after section 293(b) of the Internal Revenue Code of 1939, not section 6653 of the Internal Revenue Code of 1954. Under the 1939 Code, the late filing penalty and the fraud penalty were not mutually exclusive. (See, e.g., Richard Law, 2 T.C. 623 (1943); Ollie V. Kessler, 39 B.T.A. 646 (1939); Nicholas Roerich, 38 B.T.A. 567 (1938).) Accordingly, we conclude that respondent was not prohibited from assessing both the late filing penalty and the fraud penalty.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor;

