BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HARRY D. FIDLER)

Appearances:

For Appellant: Sheldon Berlin, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Harry D. Fidler against proposed assessments of additional personal income tax in the amounts of $3,238.97, $3,671.58 and $2,625.71 for the years 1942, 1943, and 1944, respectively.

During the years in question Appellant was associated with two other men in a business known as Ace Tool & Engineering, Inc. The three were the corporation's only stockholders, officers and directors, each of them holding approximately one-third of the stock. Appellant was the president and general manager.

The corporation handled a large volume of profitable business during this period but a substantial part of its sales was not entered in its books. The stockholders had agreed beforehand that the receipts from unrecorded sales should be divided equally among themselves. Their purpose was to evade payment of taxes and to defraud creditors of the corporation. By a corporate resolution Fidler was authorized to endorse and cash checks made payable to the corporation, Under this authorization he obtained and held the proceeds of the unrecorded sales. Out of such retained proceeds he made payments to each of the other two stockholders of approximately $75.00 per week as unrecorded salaries, together with other amounts.

During 1944 Federal internal revenue agents discovered the practice. Appellant thereafter resigned as president. In January, 1945, the corporation sued Appellant for money due and for an accounting. This action was later settled out of court. Appellant states that he repaid to the corporation "by way of settlement ... in excess of $7,500.00."

Appellant was also indicted in 1945 under the Penal Code of California for falsifying the corporate books with an intent to defraud and for grand theft of the corporation's funds. He pleaded guilty to the first charge and the charge of theft was dismissed. He was fined $1,000 and sentenced to prison for six months. In 1949 he was sentenced to imprisonment in a Federal penitentiary for evasion of Federal income taxes,

In 1954 the corporation appealed from Federal income tax deficiencies assessed against it for 1942 and 1943 based upon the concealed income. The corporation contended that funds retained by Appellant were deductible embezzlement losses. The Tax Court found that the funds were withheld by and for the stockholders and were not embezzled from the corporation. Thus the assessments were upheld (Ace Tool & Eng., Inc., 22 T. C. 833).

Appellant's income tax returns filed with the Franchise Tax Board for the years in question did not report the funds diverted from the corporation and retained by him for his personal use, In reliance upon Commissioner v. Wilcox, 327 U.S. 404, he contends that none of the diverted funds retained by him was taxable income because he embezzled the money from the corporation.

The Wilcox case involved a bookkeeper who was convicted of embezzling money from his employer. The court held that the money was not taxable income of the bookkeeper because he did not have a bona fide claim of right to it and there was an unconditional obligation to repay the employer. Subsequently, the Supreme Court held that extorted money was taxable income and expressly limited the Wilcox decision to its facts (Rutkin v. U. S., 343 U.S. 130). So far as we are aware, the Wilcox decision has been followed in only one case, where the court felt there was clearly embezzlement involved (J. J. Dix, Inc. v. Commissioner, 223 Fed. 2d 436, cert. den. 350 U.S. 894).

On the other hand, where, as in the case before us, funds are diverted from the corporation with the consent of those who control it, the courts have held that the Wilcox rule does not apply and that the funds retained by the individuals constitute income taxable to them (Drybrouah v. Commissioner, 238 Fed. 2d 735; Kann v. Commissioner, 210 Fed. 2d 247, cert. den. 347 U.S. 967; Estate of Helene Simmons, 26 T. C. 409). On the very facts before us, the Tax Court has held that the funds were not embezzled and thus were not deductible by the corporation (Ace Tool & Eng., Inc., supra). A statement in the Drybrough case, supra, is pertinent here:

> "How much vitality continues to reside in the Wilcox rule since the Supreme Court's decision in Rutkin v. U. S. . . . is a question not easy to answer,,.. We are convinced in any event that whatever authority the Wilcox rule retains is too narrow to encompass the facts of the present case. The petitioners were not employees who embezzled from an unwitting employer, but officers, directors and stockholders in complete domination and control of their corporation."

The Appellant has suggested that since he repaid $7,500 to the corporation in settlement of its suit against him, the situation is comparable to a loan, part of which is forgiven. This theory is untenable. There is only an allegation in Appellant's brief that anything was repaid, There is no evidence to support the allegation. Also, there is no showing in support of the loan theory that there was an intent to repay at the time the money was taken (see Estate of Helene Simmons, supra). As indicated in Ace Tool & Eng., Inc., supra, it is entirely possible that the suit by the corporation was instituted solely to give an appearance of disavowing the tax evasion scheme. In Kann v. Commissioner, supra, the fact that a note promising repay was subsequently given to the corporation did not affect the result and in Drybrough v. Commissioner, supra, the fact that all of the funds were subsequently repaid to the corporation did not affect the result,

The Franchise Tax Board has estimated the amounts retained by Appellant based upon an audit of the corporation made by a certified public accountant, and upon findings of the Tax Court in Ace Tool & Eng., Inc., supra, respecting the amounts retained by the other shareholders. As a result, Appellant is charged with approximately 75% of the amounts diverted. Obviously, the division determined by the Franchise Tax Board is not in accord with the original agreement between the three shareholders. This does not mean, however, that there is any reason to believe that Appellant did not keep these funds.

The unequal division may have resulted from a subsequent agreement or from fraud against the other shareholders. If by some wrong, there is no more reason to conclude it was through embezzlement, as in the Wilcox case, than there is to conclude that it was through extortion, as in the Rutkin case, 'No evidence has been offered by Appellant to contradict the estimate or to explain the reason for the unequal distribution. For all that appears, Appellant, as in the Rutkin

case, derived a "readily realizable economic value" from the funds in the amount charged to him by the Franchise Tax Board and therefore the entire amount constitutes income to him.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Harry D. Fidler against proposed assessments of additional personal income tax in the amounts of $3,238.97, $3,671.58 and $2,625.71 for the years 1942, 1943, and 1944, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of February, 1958, by the State Board of Equalization.

Geo. R. Reilly, Chairman

J. H. Quinn, Member

Paul R. Leake, Member

Robert E. McDavid, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary