BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
M. HUNTER AND MARTHA J. BROWN)

Appearances:

For Appellants: M. Hunter Brown, in pro. per.

For Respondent: Paul Petrozzi
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise. Tax Board on the protest of M. Hunter and Martha J. Brown against proposed assessments of additional personal income tax and fraud penalties as follows:

Taxpayer	Year	Tax	Fraud Penalty
M. Hunter and Martha J. Brown	1959	$1; 580.57	$790.29
M. Hunter Brown	1960	603.28	301.64
Martha J. Brown	1960	627.28	313.64

As a result of litigation concerning appellants' federal income tax liability for the same years, respondent has withdrawn the entire assessment for 1959 and the assessment against Martha J. Brown for 1960. Accordingly, the only items now at issue are the additional tax and fraud penalty assessed against appellant M. Hunter Brown for 1960.

The following factual narrative is taken entirely from respondent's brief which incorporated by reference the opinion of the United States Tax Court in M. Hunter Brown, T. C. Memo., Feb. 19, 1968. Respondent called no witnesses and offered no testimonial evidence. 1/

Appellant has been a practicing neurosurgeon in the Los Angeles area since 1949. He was married to Martha J. Brown throughout 1959 and 1960, although they were subsequently divorced, For the year 1960 they filed separate federal and California personal income tax returns. Sometime in 1961 the Internal Revenue Service initiated an extensive audit of the spouses' federal returns, leading ultimately to the assessment of large deficiencies and fraud penalties for the years 1959 through 1961. After receiving copies of the federal audit reports from the Internal Revenue Service, respondent followed the reports where applicable to California law and issued proposed assessments based entirely on the federal adjustments. The proposed adjustments also included the 50 percent fraud penalty provided for in section 18685 of the Revenue and Taxation Code.

The principal adjustments were due to appellant's omission of substantial receipts from his medical practice. Appellant's business records consisted mainly of individual ledger cards maintained for his patients. His 1957 federal return had previously been 'audited in 1959 and he was informed by' the revenue agent, that this record keeping system wa's inadequate. The federal agent explained that the ledge? cards were not satisfactory records because they could be lost, misplaced, misfiled, or removed from' the boxes' for a variety of reasons. Appellant was advised to keep a cash receipts journal in which he should record all business receipts. Nevertheless, appellant continued to use the ledger card

1/ The only other evidence offered by respondent was: a copy of the federal revenue agent's report, dated June 11, 1965, and attachments thereto; a copy of appellant's 1960 state income tax return and attachments thereto; and respondent's Notice of Additional Tax Proposed to be Assessed, dated April 19, 1966.

system. During the 1961 audit the federal agent determined that such records did not accurately reflect appellant's income for the years in question. Therefore, appellant's business income was reconstructed through an examination of his bank records. The reconstruction of appellant's business income resulted in an increase of business receipts in the amount of $15,821.62. In addition to redetermining appellant's business receipts the federal authorities." disallowed, in part, numerous alleged business expenses deducted by appellant. These expenses were disallowed on the basis that they were either personal expenses or were unsubstantiated.

During the course of the federal audit the agent. determined that appellant failed to report substantial amounts of dividend and interest income as well as his share of distributions from a testamentary trust. Another significant adjustment was the disallowance of appellant's farm loss, The basis for denial of this claimed loss was that appellant's alleged "citrus grove" operation was not entered into for profit. Appellant's claimed itemized deductions for contributions and interest expense were also reduced.

Finally, the Internal Revenue Service imposed the 50 percent fraud penalty pursuant to section 6653(h) of the Internal, Revenue Code of 1954.

Appellant petitioned the United States Tax Court for a redetermination of the deficiencies and penalties. The Tax Court upheld the deficiency assessment and the fraud penalty for the year 1960. (M. Hunter Brown, supra.) The decision-of the. Tax Court was affirmed upon appeal by the Ninth Circuit Court of Appeals. (Brown v. Commissioner, 418 F. 2d 574.)

Respondent issued notices of proposed assessment for, the years 1959 and 1960 in accordance with the federal audit reports. No independent investigation was conducted by respondent. Appellant protested the notices on behalf of both him and his wife for both years. Respondent denied appellant's protests and affirmed all of the original assessments. Thereafter, respondent became aware of the federal judicial proceedings and has conceded that there are no additional tax or penalties due from appellant and Martha J. Brown for 1959, or from Martha J. Brown for 1960. Only the proposed assessment and- fraud penalty against appellant M. Hunter Brown for 1960 are still in issue in this appeal.

Initially, we observe that appellant never reported to respondent the changes made by the Commissioner of Internal Revenue to his 1960 federal income tax return as required by section 18451 of the Revenue and Taxation Code. Section 18586.2 of the Revenue and Taxation Code provides that where the taxpayer fails to report such federal changes as required by section 18451 a notice of proposed deficiency resulting from the federal adjustments may be mailed to him within four years after the changes. Here, the 1960 federal audit report was dated June 11, 1965, and respondent's notice of proposed assessment based thereon was sent April 19, 1966, well within the applicable four year limitations period set out in section 18586.2.

Appellant's main contention is mat the federal audit report was not a sufficient basis for respondent's assessment. However, contrary to appellant's contention, it has long been held that a deficiency assessment issued by respondent on- the basis of a federal audit report is presumed to be correct, and the burden is on the taxpayer to show that it is incorrect. (Appeal of Paritem and Janie Poonian, Cal. St. Rd. of Equal., Jan. 4, 1972; Appeal of henrietta Swimmer, Cal. St. Rd. of Equal., Dec. 10, 1963.) Since appellant has not seen fit to offer any substantive evidence to show' wherein the federal determination was erroneous, we conclude that respondent's action with reference to the deficiency assessment was correct.

However, a different question is presented when we consider the application of the fraud penalty. The burden of proving fraud is upon respondent, and it must be established by something impressively more than a slight preponderence of the evidence. It must be proved 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. (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 p. 61) it is never presumed or imputed, and it will not be sustained upon circumstances which, at most, create only suspicion. (Jones v. Commissioner, supra at p. 303.)

Initially, it appears that respondent contends that it may satisfy its burden of establishing fraud by clear and convincing

a

evidence merely by relying on the federal audit report where the federal fraud penalty was asserted. This it cannot do. It has long been held that the taxing authority may not sustain its burden of proof on a fraud issue by statements made in the notice of deficiency. (James Nicholson, 32 B. T. A. 977, 988-989; Oscar G. Joseph, 32 B. T. A. 1192, 1204.)

In support of its position that it properly asserted the fraud penalty in reliance on the federal audit report, 'respondent places heavy reliance on the fact that the Internal Revenue Service's action was upheld by the United States Tax Court and the Ninth" Circuit Court of Appeals. It is true, as respondent maintains, that in matters involving deficiency assessments we have held that the disposition of a taxpayer's case on the federal level, after review by both trial and appellate courts is highly persuasive of the result that should be reached by this board,. (See Appeal of Estate of Adam Holzwarth. Deceased. and Maw Holzwarth, Cal. St,. Bd. of Equal., Dec. 12, 1967; Appkal of Reginald G. and Mary Louise Hearn, Cal. St. Bd. of Equal., May 10.1967; cf. Appeal of Robert, C. Sherwood. Deceased. and Irene Sherwood=t. Bd. of Equal., Nov. 30, 1965.) However, this is not to say that a disposition at the federal level is conclusive. This observation is especially relevant in a fraud case 'where the demeanor of the parties 'and their witnesses often control the final resolution of the matter. We are most reluctant to approve the assessment of so serious a sanction as the civil fraud penalty on the basis of a Tax Court Memorandum Opinion and a per curiam affirmance by a reluctant Court of Appeals 2/ without the opportunity of personally observing

2/ Brown v. Commissioner, 418 F. 2d 574, is hereinafter quoted' in its entirety:

> Brown is a noted neurosurgeon. The government took exception to some of his income tax returns, and deficiencies and fraud penalties were asserted by the Commissioner.
>
> Brown tried his own case in the Tax Court. He there handled the case about as badly as the three judges of this panel would have handled a neurosurgical operation. The Tax Court entered a decision against him, finding a' considerable deficiency and fraud with its usual fifty' percent penalty.

(Continued 'on next page)

the witnesses. The necessity for personal observation of the parties and witnesses in order to determine their capacity for competency, knowledge, perception and honesty is forcefully borne out in this matter by the determination of appellant's federal liability in the Tax Court which, to a great extent, turned on the credibility of certain witnesses in that proceeding.

We note that in neither of the matters cited. by respondent in support of its position was fraud at issue. However,, in Appeal of Robert C. Sherwood, Deceased, and Irene Sherwood, supra, we were called upon to consider the effect of a prior federal criminal conviction for tax evasion after a trial on the merits. In Sherwood we stated:

> [T]he courts attach considerable significance to a criminal conviction in determining the facts in a civil case. We are not unmindful of the fact that the evidence here consists of a federal 'rather than a state conviction. The federal and state income tax laws are substantially the same, however, and the same amounts were reported on the federal and state returns. Whether the federal conviction is regarded as creating an estoppel or as rebuttable evidence it is sufficient to persuade us, in the absence of any rebuttal, that the state return, like the federal return, was fraudulent.

Sherwood can be distinguished by the fact that in the taxpayer's criminal conviction, the prosecution's burden was to establish fraud beyond a reasonable doubt, whereas, in a civil fraud case the taxing authority has only to establish its case by clear and convincing evidence. Thus, we were' especially persuaded that

---

On appeal, too late, he has hired very competent counsel. But stuck. in the mud with the trial record, counsel simply cannot pull the doctor out.

We find there was competent evidence to sustain the decision unless absolute mathematical certainty be required. And 'it is not required. The fact that there was some conflicting, evidence does not prevent a conclusion that there was clear and convincing evidence to sustain the Tax Court's findings and conclusions.

The decision is affirmed.

the conviction in a criminal fraud case, where the government is held to the more stringent burden of proof would necessarily be dispositive of the same issue in a subsequent civil fraud case where the burden of proof, although still onerous, is considerably less. In the absence of anything more, and respondent has offered nothing more, we are not compelled to accept as conclusive a determination by a federal court on the issue of a civil fraud penalty.

Similarly, respondent may not carry its burden of proof on the issue of fraud merely by relying on section 18451 of the Revenue and Taxation Code. Section 18451 provides, in pertinent part:

> If the amount of gross income or deductions for any year of any taxpayer as returned to the United States Treasury Department is changed or corrected by the Commissioner of Internal Revenue... such taxpayer... shall concede the accuracy of such determination or state wherein it is erroneous. (Emphasis added.)

It is readily apparent from the wording of the statute that although the taxpayer may, under certain circumstances, be required to concede the accuracy of a federal determination of his "gross income or deductions" no similar concession is required in the case of a fraud penalty.

Accordingly, it is our determination that respondent has not established by clear and convincing evidence that the civil fraud penalty contained in section 18685 was properly asserted against appellant for the year 1960.

Appellant has also asserted his right to a refund, with interest, of the state tax he paid on behalf of his ex-wife for the years 1959 and 1960. However, we are unaware of any timely claim for refund ever being filed on appellant's behalf. Accordingly,, any question concerning the propriety of a claim for refund is not properly before this board at this time.

ORDER

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 protest of M. Hunter Brown and Martha J. Brown against proposed assessments of additional personal income tax and fraud penalties against M. Hunter Brown and Martha J. Brown, jointly, in the amount of $1,580.57 tax and $790.29 fraud penalty for the year 1959, and against Martha J. Brown, individually, in the amount of $627.28 tax and $313.64 -fraud, penalty for the year 1960, be and the same is hereby modified to reflect respondent's withdrawal of the assessments; that the action of the Franchise Tax Board on the protest of M. Hunter Brown and Martha J. Brown against a proposed assessment of additional personal income tax against M. Hunter Brown, individually, in the amount-of $603.28 for the year 1960, be and the same is hereby' sustained, and that the action of the Franchise Tax Board on the protest of M. Hunter Brown and Martha J. Brown against a proposed assessment of fraud penalty against M. Hunter Brown, individually, in the amount of $301.64 for the year 1960, be and the same is hereby reversed.

Done at Sacramento, California, this 7th day of October, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____ Secretary