

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
) DOCKET NO. 25102
[REDACTED],)
)
)
Petitioner.) DECISION
)
_____)

[Redacted] (petitioner) protests the Notice of Deficiency Determination (NODD) issued by the auditors for the Idaho State Tax Commission (Commission) dated May 15, 2012, asserting an additional liability for Idaho income tax, penalty, and interest in the total amount of \$109,135 and \$799,207 for 2009 and 2010, respectively.

The auditors made several adjustments to the Idaho taxable income reported by the petitioner. For 2010, the auditors asserted that the petitioner had received \$12,500 in wages from [Redacted] and had failed to report this income. The auditors found that the petitioner had underreported her income by the amounts of \$352,307 and \$6,018,314 for 2009 and 2010, respectively. The auditors disallowed business expenses claimed by the petitioner in the amounts of \$53,403 and \$270,867 for 2009 and 2010, respectively. The auditors disallowed deductions for the cost of goods sold in the amounts of \$482,044 and \$317,732 for 2009 and 2010, respectively. After the issuance of the NODD, the petitioner supplied additional documentation to verify an additional amount of cost of goods sold for 2010 in the amount of \$247,909. The auditors also asserted the civil fraud penalty.

The petitioner operated [Redacted] and reported the activity on a Schedule C (Profit or Loss from Business) of her income tax returns. On this Schedule, she deducted wages purportedly paid to herself in the amount of \$12,500, but failed to include these wages as income. She also failed to claim credit for the Idaho income tax withheld from those wages in

the amount of \$92. The auditors included both the income and the withholding in the computation of the amount asserted for 2010 in the NODD. The petitioner did not object to these specific adjustments or provide additional information regarding the other issues involved in this docket.

The auditors examined the petitioner's bank statements including bank accounts not disclosed to the auditors by the petitioner. In those accounts, the auditors found what appeared to be significantly more income than was reported by the petitioner. The petitioner failed to explain why the amounts were not reported as income, or why the amounts in question were not includable in the computation of her Idaho taxable income. Accordingly, the auditors included these amounts in the petitioner's income. The petitioner has failed to provide a logical explanation for the omission of these funds.

The auditors used a bank deposit analysis in determining the petitioner's income. In addressing the application of the bank deposit analysis, the Tax Court stated, in part:

In the instant cases, the IRS chose to apply the bank deposits method. A bank deposit is prima facie evidence of income. Tokarski v. Commissioner, 87 T.C. 74, 77, 1986 WL 22155 (1986); see also Clayton v. Commissioner, 102 T.C. 632, 645, 1994 WL 135337 (1994); DiLeo v. Commissioner, supra at 868; Estate of Mason v. Commissioner, supra at 656. When a taxpayer keeps no books or records and has large bank deposits, the IRS is not acting arbitrarily or capriciously by resorting to the bank deposits method. DiLeo v. Commissioner, supra at 867. The bank deposits method of reconstruction assumes that all of the money deposited into a taxpayer's account is taxable income unless the taxpayer can show that the deposits are not taxable. See *id.* at 868; see also Price v. United States, 335 F.2d 671, 677 (5th Cir.1964). The IRS need not show a likely source of the income when using the bank deposits method, but the IRS must take into account any nontaxable items or deductible expenses of which the IRS has knowledge. See Price v. United States, supra at 677; Tokarski v. Commissioner, supra at 77.

Enayat v. Commissioner, T.C. Memo 2009-257.

It appears that the auditors discovered sources of funds available to the petitioner and that the petitioner has failed to establish that the funds were not income to her. Accordingly, the Commission finds that this adjustment must be affirmed.

The auditors also adjusted the allowable amounts claimed as cost of goods sold and for other deductions claimed by the petitioner on her Schedule C for [Redacted]. The auditors examined documentation presented by the petitioner and allowed the expenses substantiated by the petitioner and deemed to be ordinary and necessary business expenses. During this administrative appeal, however, the petitioner has presented no additional documentation or argument to bolster her position. With regard to the burden of proof for deductions, the U.S. Supreme Court stated, in part:

Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.

* * *

Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.

New Colonial Ice Co., Inc v. Helvering, 292 U.S. 435, 440 (1934).

The petitioner had the burden of showing that she was entitled to the deductions in question, and failed to do so. Accordingly, the Commission finds that the petitioner is not entitled to the claimed deductions disallowed by the auditors.

The last issue is the assertion of the civil fraud penalty. The authority for this penalty is set out in Idaho Code § 63-3046(b) which stated:

If any part of any deficiency is due to fraud with intent to evade tax, then fifty percent (50%) of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected and paid.

In consideration of the application of the civil fraud penalty in a tax case, the Idaho Supreme Court stated, in part:

The intent of the Idaho Income Tax Act is to make the provisions of the Act “insofar as possible ... identical to the provisions of the Federal Internal Revenue Code.” I.C. § 63-3002. The Ninth Circuit has addressed the elements of civil tax fraud. In a case involving the 50 percent penalty of the Federal Internal Revenue Code, the Ninth Circuit stated that “[i]n the context of the 50 percent penalty ... fraud is intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing.” Conforte v. Commissioner, 692 F.2d 587, 592 (9th Cir.1982). The burden is on the Commissioner to establish fraud by clear and convincing evidence, but intent can be inferred from strong circumstantial evidence. Bradford v. Commissioner, 796 F.2d 303, 307, (9th Cir.1986)(citing Conforte, 692 F.2d at 592; Spies v. United States, 317 U.S. 492, 499, 63 S.Ct. 364, 368, 87 L.Ed. 418, 423 (1943)).

Federal law has also recognized “badges of fraud,” from which intent to defraud may be inferred. Bradford, 796 F.2d at 307. These “badges of fraud” include “(1) understatement of income; (2) inadequate records; (3) failure to file tax returns; (4) implausible or inconsistent behavior; (5) concealing assets; and (6) failure to cooperate with tax authorities.” *Id.* (citations omitted).

[6] It is therefore appropriate to adopt the definition of “tax fraud” as defined by federal courts, which is “intentional wrongdoing on the part of the taxpayer with the specific intent to avoid taxes known to be owing.” Conforte, 692 F.2d at 592. This wrongdoing may be proven through strong circumstantial evidence. Spies, 317 U.S. at 499, 63 S.Ct. at 368, 87 L.Ed. at 423; see also Bradford, 796 F.2d at 307; Pittman v. Commissioner, 100 F.3d 1308, 1319 (7th Cir.1996).

Idaho State Tax Commission v. Hautzinger, 137 Idaho 401, 403-404, 49 P.3d 406, 408-409 (2002).

In discussing the application of the fraud penalty, the U. S. Tax Court stated, in part:

The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), *affd.* without published opinion 578 F.2d 1383 (8th Cir.1978); Estate of Pittard v. Commissioner, 69 T.C. 391 (1977). Fraud is not to be imputed or presumed, but rather must be established by some independent evidence of fraudulent intent. Beaver v. Commissioner, 55 T.C. 85, 92 (1970); Otsuki v. Commissioner, 53 T.C. 96 (1969). Fraud may not be found under “circumstances which at the most create only suspicion.” Davis v. Commissioner, 184 F.2d 86, 87 (10th Cir.1950); Petzoldt v. Commissioner, 92 T.C. 661, 700 (1989). However, fraud may be proved by circumstantial evidence and reasonably inferred from the facts, because direct proof of the taxpayer's intent is rarely available. Spies v. United States, 317

U.S. 492 (1943); Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Stephenson v. Commissioner, 79 T.C. 995 (1982), affd. 748 F.2d 331 (6th Cir.1984). A taxpayer's entire course of conduct may establish the requisite fraudulent intent. Stone v. Commissioner, 56 T.C. 213, 223 224 (1971); Otsuki v. Commissioner, supra at 105-106. The intent to conceal or mislead may be inferred from a pattern of conduct. See Spies v. United States, supra at 499.

Courts have relied on several indicia of fraud when considering the section 6653(b) addition to tax. Although no single factor may conclusively establish fraud, the existence of several indicia may be persuasive circumstantial evidence of such. Solomon v. Commissioner, 732 F.2d 1459, 1461 (6th Cir.1984), affg. per curiam T.C.Memo. 1982 603; Beaver v. Commissioner, supra at 93.

Circumstantial evidence which may give rise to a finding of fraudulent intent includes: (1) Understating income; (2) keeping inadequate or no records; (3) failing to file tax returns; (4) maintaining implausible or inconsistent explanations of behavior; (5) concealing assets; (6) failing to cooperate with tax authorities; (7) filing false Forms W-4; (8) failing to make estimated tax payments; (9) dealing in cash; (10) engaging in illegal activity; and (11) attempting to conceal an illegal activity. Bradford v. Commissioner, 796 F.2d 303, 307 (9th Cir.1986), affg. T.C.Memo. 1984 601; see Douge v. Commissioner, 899 F.2d 164, 168 (2d Cir.1990). These "badges of fraud" are nonexclusive. Miller v. Commissioner, 94 T.C. 316, 334 (1990). Both the taxpayer's background and the context of the events in question may be considered as circumstantial evidence of fraud. United States v. Murdock, 290 U.S. 389, 395 (1933); Spies v. United States, supra at 497; Plunkett v. Commissioner, 465 F.2d 299, 303 (7th Cir.1972), affg. T.C.Memo. 1970-274.

Verdunn v. Commissioner, T. C. Memo 1995-117.

The income reported by the petitioner was far short of the amounts of receipts shown by the auditors in their bank deposit analysis. The petitioner reported gross receipts of \$647,907 and \$2,206,995 for 2009 and 2010, respectively. The auditors found that the petitioner had underreported gross receipts by \$352,307 and \$6,018,314 for 2009 and 2010, respectively.

The petitioner claimed business expenses on her 2009 Schedule C in the total amount of \$148,450. Of this amount, the auditors found that the petitioner had not properly documented \$53,403 or nearly 36 percent of the claimed deductions. For 2010, the petitioner claimed business expenses in the total amount of \$490,809. The auditors found that the petitioner had not

properly documented \$270,867 of such expenses or more than 55 percent of the claimed deductions.

The petitioner claimed cost of goods sold for 2009 in the amount of \$482,044. The auditors found that she had failed to properly substantiate any of the claimed cost of goods sold. For 2010, the petitioner claimed cost of goods sold in the total amount of \$1,664,752. The auditors found that the petitioner failed to properly substantiate \$69,823.

The claiming of business deductions and cost of goods sold substantially in excess of the amounts verified by the petitioner shows, at best, that the petitioner had failed to keep adequate books and records.

The petitioner stated that she had bank accounts at two different banks. The auditors discovered that the petitioner had nine bank accounts at four different banks. The petitioner contended that the other accounts must belong to someone else. However, the identification to open the bank accounts was an [Redacted] driver's license issued to a [Redacted] and she was a signor on the accounts. The mailing address for each of the accounts was either the petitioner's home address or her business address. Additionally, as was mentioned above, [Redacted] (the petitioner's business) issued a W-2 to the petitioner deducting the wage expense, but failed to report the related income on her return.

The information in the file indicates that the petitioner was experienced in the type of business she operated. Accordingly, she knew or should have known, the need for records sought by the auditors. The record indicates that the petitioner's parents operated a similar business and that she had been employed by similar businesses in Idaho.

The record before the Commission shows that the petitioner failed to keep adequate books and records, failed to report substantial portions of her income, and misrepresented the

facts to the auditors. The Commission finds these factors taken together supply adequate circumstantial evidence to show that the deficiency is due to fraud with intent to evade tax.

THEREFORE, the Notice of Deficiency Determination dated March 29, 2012, is hereby MODIFIED, and as so MODIFIED, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioner pay the following tax, penalty, and interest (calculated to February 15, 2013):

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2009	\$ 68,272	\$ 34,136	\$ 8,150	\$110,558
2010	495,925	247,963	55,641	<u>799,529</u>
				<u>\$910,087</u>

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioner's right to appeal this decision is enclosed.

DATED this _____ day of _____ 2012.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2012, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.
