

fraud until after the stock purchase, the fraud penalty should be deleted and the three-year statute of limitations applied.

Summary

Petitioners are cosmetology schools which make sales of student kits and beauty aid items. The corporation, --- started business in August of 1978, and the corporation, --- started business in May of 1976. On each of the respective starting dates, the president and sole shareholder of each corporation was ---.

On January 2, 1990, --- purchased all of the stock of both --- and --- later changed the names to --- and --- respectively, closed out the existing seller's permits for --- and --- and obtained new seller's permits for these same corporations which reflects the new corporate names.

After receiving a tip from an ex-employee that --- had intentionally underreported tax for his various businesses, the Sales and Use Tax Department (SUTD) decided to conduct an audit. During the audit, it was noted the general ledger sales tax accrual account routinely only included tax charged and collected for over the counter sales of beauty aids. The auditor further discovered sales of student kits when she noted the sales price stated on the face of various student contracts. In most cases, a separate charge was made for sales tax reimbursement; however, a few contracts were noted as "tax included". The tax collected from kit sales was not included in the tax accrual account, but rather in an account under the heading of "tuition". The result was an understatement of 780 percent for --- and 1,264 percent for --- Based on this discovery, and verbal and written statements from former employees that --- intentionally failed to pay the tax, the audit period was extended and a fraud penalty added. Dual determinations were issued to both corporations under the former and current account numbers indicated above.

At the conference, former --- employee --- (currently working for ---, stated that she advised --- that tax was not being reported on the sales of kits. --- allegedly told her to just report over-the-counter sales, and that tax had never been reported on kit sales. She stated that his philosophy concerning taxes was to report the least, give the least, or know the least amount --- was employed by --- from approximately October 4, 1988 through February 3, 1990. She was hired as a bookkeeper and one of her duties was to prepare the sales tax returns. --- has also provided a written statement.

--- who worked for petitioner between April of 1980 through July 7, 1986 was originally hired by --- as an administrative assistant and later made vice president. One of her duties was to prepare sales tax returns for the majority of the audit period. Her written statement indicates she advised --- that tax was not being paid on kit sales. He instructed --- to prepare the reports in the method she had been shown by her predecessor (not report tax on kit sales).

--- pointed out that at the time of his January 2, 1990 stock purchase, he was unaware of, --- previous actions. He feels it is unfair to penalize him for something ---, did, when --- neither knew nor participated in the fraud. He acknowledged that he received a settlement from --- based on a clause in the stock purchase agreement that provided for --- to reimburse ---- for any liability incurred as a result of this audit.

SUTD argues that the fraud penalty was asserted against the corporation; therefore, even though --- had neither knowledge nor participation in the fraud, the penalty would still apply.

Analysis and Conclusions

Revenue and Taxation Code Section 6485 imposes a 25 percent penalty if any part of a deficiency is due to fraud or intent to evade the Sales and Use Tax Law. In Marchica v. State Board of Equalization, 107 Cal.App.2d 501, the court stated at page 510 that fraud is never presumed and must be established by proof. In various published and unpublished rulings, this Board has interpreted Marchica as requiring proof by clear and convincing evidence. More recently, however, the California Supreme Court has held that fraud in civil cases need only be established by a preponderance of the evidence. (Liodas v. Sahadi (1977) 19 Cal.3d 278.)

The general rule is that corporations are liable for fraud committed by their agents and employees, even if the corporate officers were not aware of the fraud nor the corporation benefitted. (See Rutherford v. Rideout Bank, 11 Cal.2d 479; Ghiglione v. American Trust Co., 49 Cal.App.2d 633.) The federal courts have applied this rule in income tax cases and upheld fraud penalties when "the agent was acting in behalf of and not against the corporation with the result that the corporation benefitted from this fraudulent acts." (Ruidoso Racing Association, Inc. v. Commissioner, 476 F.2d 502 at 506.)

Revenue and Taxation Code Section 6487 imposes time limitations within which a notice of deficiency determination must be mailed, "except in the case of fraud". Since the determination in question involves fraud, the statute of limitations does not bar collection of the tax.

Based on the facts presented, it is clear that --- knowingly and intentionally underpaid sales tax. The evidence is uncontroverted that he was advised tax was not being paid on kits sales, yet told those employees to only report tax on over-the-counter sales. Tax was collected on most of the unreported sales, yet the information was not entered into the tax accrual account. As a result, there was significant understatement of tax.

As to whether or not --- would be entitled to relief as an innocent shareholder, Section 6485 expressly provides that if any part of a deficiency determination is due to fraud, the 25 percent penalty shall be added. The logical interpretation of this language leads to the conclusion that the penalty must be imposed in a situation such as this.

Here, the corporation was not an unsuspecting victim of --- acts. He owned all the stock, controlled all the accounting functions, and directed the acts of the corporate employees which assured that tax would be intentionally underreported. Accordingly, no relief can be granted. Although it was not the basis for this decision, it should be further noted that because --- has settled with --- the corporation has suffered no loss.

Recommendation

Deny all petitions.

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Date