

Cite as Det. No. 99-141, 19 WTD 638 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 99-141
)	
...)	Registration No. . . .
)	FY. . . /Audit No. . . .

RULE 228; RCW 82.32.090: EVASION PENALTY. Poor judgement brought on by illness and financial pressures is not a defense to the 50% evasion penalty, where the evasion was proven to be knowing and intentional.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this determination.

NATURE OF ACTION:

Corporate taxpayer appeals assessment of evasion penalty on the basis that the corporate officer who deliberately underreported taxes was seriously ill.¹

FACTS:

Munger, A.L.J. -- The taxpayer, . . . , was audited by the Department of Revenue (the Department) for the period of January 1, 1993 through December 31, 1996. Prior to the start of the audit on April 16, 1997, and after an audit appointment letter had been sent, taxpayer's counsel notified the Department the taxpayer had informed him that it had underreported income and collected retail sales tax it failed to remit.

During the audit period . . . was the taxpayer's president and was responsible for filing and paying state taxes. During this time period the taxpayer collected substantial amounts of retail sales tax from customers. . . . [T]he president underreported sales when reporting income to the state, and as a result, converted by using \$. . . of unremitted retail sales taxes he collected to pay other expenses during the audit period.² An investigation showed that the president alone prepared the excise tax returns. Because money was tight, he would pay employees before

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

² The taxpayer was also assessed an additional \$. . . in retailing and \$. . . in wholesaling B&O taxes.

paying the collected retail sales tax trust funds. In preparing the state tax returns he would calculate how much he could afford to pay and report less sales accordingly, so that the returns would not show all the sales taxes actually owing. The taxpayer's business records were well kept and showed its full income as well as retail sales taxes collected. Federal taxes were correctly reported. As a result of the deliberate underreporting of sales and the failure to remit collected retail sales taxes, the Audit Division also imposed the RCW 82.32.090(5) 50% evasion penalty.

The Audit report states:

2. You have collected retail sales taxes from customers and recorded the tax collected in your 230 account. Only a portion of your sales were reported on Washington excise tax returns and as a result, only a portion of the retail sales tax collected from customers has been remitted to the state.
3. During the audit period you accurately reported your business activities to the Internal Revenue Service and to other Washington State agencies.

The taxpayer admits the underreporting, does not dispute the additional tax assessments and only appeals the evasion penalty.

During the audit time period and for several years prior, the president had been seriously ill with Hepatitis C and may need a liver transplant. That the taxpayer's president was and still is seriously ill is not disputed. The illness has caused him to forget things, become confused, have mood swings, and be continuously fatigued. One of his doctors states that "His mental acuity, judgment, and ability to make decisions in his business have been compromised for at least five years." Despite these problems, taxpayer admits that its president was aware of the requirement to report and remit the collected retail sales taxes. He was also experiencing financial problems due to his inability to devote full time to his work. No evidence has been presented that taxpayer's president prepared and filed the state tax returns by mistake or without knowing what he was doing.

ISSUE:

Is poor judgment, brought on by business pressures and serious health problems a defense to the evasion penalty, where the evidence shows that taxes were deliberately under reported with full knowledge of the tax reporting requirements?

DISCUSSION:

The Department's authority to impose the fifty- percent evasion penalty is set forth in RCW 82.32.090(5), which states in part:

If the department finds that all or any part of the deficiency resulted from intent to evade the tax payable hereunder, a further penalty of fifty percent of the additional tax found to be due shall be added.

(Emphasis added.) By using the word "shall," the legislature has indicated that the penalty is mandatory if intent to evade is found. Although the subjective intentions of a person are difficult to ascertain, they may be determined from objective facts, including the actions or statements of the taxpayer. Det. No. 87-188, 3 WTD 219 (1987).

WAC 458-20-228 (Rule 228) is the Department's administrative rule implementing RCW 82.32.090(5). Like all of the Department's rules, Rule 228 has the same force and effect as a statute enacted by the legislature unless declared invalid by the judgment of a court of record not appealed from. See, RCW 82.32.300. Rule 228 provides in part:

If the department finds that all or any part of the deficiency resulted from intent to evade the tax due, a penalty of fifty percent of the additional tax found to be due shall be added.

WAC 458-20-230 (Rule 230) sets forth the standard of proof that must be met by the Department in order to impose the evasion penalty. Rule 230 provides in part that:

The evasion must be shown by clear, cogent, and convincing evidence, which is objective and creditable.

The phrase "intent to evade" is not defined in either RCW 82.32.090(5) or Rule 228. However, the Department's interpretation of that phrase is set forth in Rule 230, which provides in part that:

Evasion involves a situation where the taxpayer knows a tax liability is due and the taxpayer attempts to evade detection through deceit, fraud, or other intentional wrongdoing.

Thus, imposition of the evasion penalty requires proof of the following by clear, cogent, and convincing evidence that is both objective and creditable: (1) a tax liability which the taxpayer knows is due; and (2) an attempt by the taxpayer to escape detection through deceit, fraud, or other intentional wrongdoing. Clear, cogent, and convincing evidence has been described as evidence convincing the trier of fact that the issue is "highly probable," or, stated another way, the evidence must be "positive and unequivocal." Colonial Imports, Inc. v. Carton Northwest, Inc., 121 Wn. 2d 726, 853 P.2d 913 (1993).

The taxpayer's defense is that the president's health problems caused him to exercise poor judgment. As stated in its attorney's letter of May 6, 1998:

While these testimonials certainly do not paint a picture of an individual who does not "know right from wrong" in the classic McNaghten sense, they paint a picture of an individual whose decision making skills are far below normal. In short, [the

president] has not for a period of five years or so, been capable of making sound business decisions.

The “M’Naghten Rule”, the common law definition of the insanity defense, is codified in Washington under RCW 9A.12.010.³

However, the undisputed evidence is that the president knew exactly what he was doing and did it specifically to avoid remitting collected retail sales tax trust funds. Virtually all persons who deliberately file false tax returns can be described as having exercised poor judgment. We are very sympathetic to the president’s serious health condition, however, the *motivation* for filing the false returns, *i.e.* financial difficulties brought on by poor health, is not a defense to the RCW 82.32.090(5) evasion penalty.

As we noted in Det No. 97-134R, 18 WTD 163 (1998):

The expense of the taxpayer’s drug addiction may have provided the *motivation* for the tax evasion, but *no evidence has been provided that shows he was unable to form the intent to evade taxes*. Indeed, the objective facts of this case clearly show that the elements of tax evasion have been established by the Department.

First, the taxpayer has indicated both by his conduct and his statements in his original petition that he clearly understood that his business activities were taxable. *Retail sales tax was routinely collected at the correct rate from customers. The taxpayer seriously underreported his gross receipts on excise tax returns.* In two cases the taxpayer filed “no business” excise tax returns while during this same period he collected retail sales tax on taxable transactions. In another he reported no retail sales while collecting retail sales tax from customers. *Even more egregious is that the taxpayer did not remit the collected retail sales tax trust funds to the Department.* We are not persuaded that this represents careless behavior by the taxpayer, instead it confirms he was intentionally evading his tax responsibilities.

³ The Washington criminal code define “intent” and the insanity defense as follows:

RCW 9A.08.010(a) **INTENT.** A person acts with intent or intentionally when he acts with the objective or purpose to accomplish a result, which constitutes a crime.

RCW 9A.12.010 Insanity. To establish the defense of insanity, it must be shown that:

- (1) At the time of the commission of the offense, as a result of mental disease or defect, the mind of the actor was affected to such an extent that:
 - (a) He was unable to perceive the nature and quality of the act with which he is charged; or
 - (b) He was unable to tell right from wrong with reference to the particular act charged.

By contrast, to uphold the evasion penalty, the Department must show knowledge of the tax liability (the most commonly disputed element of the evasion penalty) and deceit, fraud, or other intentional wrongdoing.

(Emphasis added.) Although the health problem is different in the present case, the circumstances are very similar. In both cases the health problems caused financial difficulties, which the taxpayer tried to cover by converting collected retail sales tax trust funds. Although the taxpayers showed poor judgment in taking the acts they did, both did so deliberately and with full knowledge of their tax responsibilities.

In summary, the taxpayer's president's serious health problems undoubtedly contributed to the taxpayer's cash flow problems. While it is also undisputed that the filing of falsified excise tax returns was clearly an act of poor judgment, it is conceded that the president was aware of his tax responsibilities and there is no evidence that the substantial underreporting of income was anything other than intentional. The Department has therefore proven by clear cogent and convincing evidence that the taxpayer knew its tax liability and attempted to evade detection through deceit, fraud, or other intentional wrongdoing.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

Dated this 24th day of May 1999.