

EAGLE'S WINGS TECHNOLOGIES, LLC
600 BOLL WEEVIL CIRCLE
ENTERPRISE, AL 36330-2715,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 05-1166

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Eagle's Wings Technologies, LLC ("Taxpayer" or "LLC") for State sales tax for September 2000 through November 2004. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on March 1, 2006. John Padgett ("Padgett") represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUE

The issue in this case is whether the Department properly assessed the Taxpayer for the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d).

FACTS

The Taxpayer sold computer parts, accessories, cellular telephones, pagers, etc. during the period in issue. Padgett and his father both owned 50 percent of the business. However, only Padgett worked at the business. His father was not involved.

The LLC obtained a sales tax license from the Department in early 2000. Padgett testified that he hired the daughter of a close family friend to help him as his office manager in July 2000. The LLC had no other employees. After hiring the office manager, Padgett spent most of his time out of the office making sales calls. The office manager was responsible for keeping the LLC's checking account, paying all bills, preparing and filing the

LLC's sales and withholding tax returns and paying all taxes due, and various other duties.

Padgett got married in September 2003. Coincidentally or not, the office manager quit her job in October 2003. Padgett took over the office at that time. He soon discovered that the LLC had not filed State sales tax returns and also State and federal withholding tax returns since mid-2000. He also found his original individual income tax returns for the subject years that he had instructed the office manager to file for him.

Padgett and his wife began organizing the LLC's records to determine what taxes had and had not been paid. He decided that because he could not file and pay all past due taxes at the same time, he would handle them one at a time. Consequently, he first contacted the IRS concerning his federal withholding liability. He then contacted, or was contacted by, the Department concerning his State withholding liability.

The Department's Collection Services employee that was working on the LLC's delinquent withholding taxes notified the Department's Dothan District Office that the LLC probably also had a sales tax problem. A Department examiner investigated and discovered that the LLC's sales tax account had been closed in August 2000, and that no returns had been filed since that time.

The examiner called on Padgett at his business in early October 2004. Padgett admitted at that time that he was liable for sales tax, and that the LLC had failed to file returns and remit the tax to the Department. He also stated that he had wondered what would happen if the Department found out that he had not been paying his sales taxes.

The Department examiner audited the LLC's books and assessed it for the tax due.

She also applied the 50 percent fraud penalty because no returns had been filed, and also because Padgett's statement that he had wondered what would happen if he was caught indicated to the examiner that Padgett had knowingly failed to report and pay the tax due.

Padgett does not dispute the tax and interest assessed by the Department. He claims, however, that the fraud penalty is inapplicable because he relied on his office manager to file and pay the LLC's taxes, and that he was not aware that she had failed to do so.

ANALYSIS

Code of Ala. 1975, §40-2A-11(d) levies a 50 percent penalty if any underpayment of tax is due to fraud. The section also specifies that the term "fraud" shall have the same meaning as ascribed in the federal fraud penalty statute, 26 U.S.C. §6663. Consequently, federal case law is applicable in determining if fraud is present for Alabama purposes. *Best v. State, Dept. of Revenue*, 423 So.2d 859 (Ala. Civ. App. 1982).

The Department is required to prove fraud by clear and convincing evidence. *Bradford v. C.I.R.*, 796 F.2d 303 (1986). "The burden is upon the commissioner to prove affirmatively by clear and convincing evidence actual and intentional wrongdoing on the part of the (taxpayer) with a specific intent to evade the tax." *Lee v. U.S.*, 466 F.2d 11, 14 (1972), citing *Eagle v. Commissioner of Internal Revenue*, 242 F.2d 635, 637 (5th Cir. 1957). The existence of fraud must be determined on a case-by-case basis, and from a review of the entire record. *Parks v. Commissioner*, 94 T.C. 654, 660 (1990).

The 50 percent fraud penalty applies "[i]f any part of any underpayment of the tax

required to be shown on a return is due to fraud.” Section 40-2A-11(d). The filing of a false or fraudulent return is not required for the fraud penalty to apply. Rather, under the federal fraud statute, which is applicable for Alabama purposes, the failure to file a return is an indication of fraud, as is the failure to report over an extended period, the failure to provide the government with access to records, and the failure to keep books and records. See, *Solomon v. Comm. of Internal Revenue*, 732 F.2d 1459 (6th Cir. 1984); see also, *U.S.A. v. Hahn*, 182 F.3d 919 (“Fraud is defined as an intent to avoid taxes; in finding fraud, the failure to file a return is a factor of particular weight. When coupled with other circumstantial evidence of fraud such as failure to keep adequate records . . . , the failure to file a return is persuasive evidence.”); *Niedringhaus v. Comm. of Internal Revenue*, 99 T.C. 202, 213 (“While the mere failure to file tax returns may not be fraudulent (cite omitted), it can be evidence of the intent to evade tax.”).

Because fraud is rarely admitted, “the courts must generally rely on circumstantial evidence.” *U.S. v. Walton*, 909 F.2d 915, 926 (6th Cir. 1990), citing *Trafficant v. Commissioner*, 884 F.2d 258, 263 (6th Cir. 1989). Consequently, fraud may be established from “any conduct, the likely effect of which would be to mislead or conceal.” *Walton*, 909 F.2d at 926, quoting *Spies v. United States*, 63 S.Ct. 364, 368 (1943). The failure to keep adequate records and the consistent underreporting of tax is strong evidence of fraud. *Wade v. C.I.R.*, 185 F.3d 876 (1999) (“There is no dispute (taxpayer) kept inadequate books and records, further suggesting fraud.”).

The LLC failed to file returns and pay its sales tax during the period in issue. That is

not conclusive of fraud, however, unless Padgett was aware at the time that the returns were not being filed.

Padgett concedes that he failed to properly oversee his business, and that he was negligent in not verifying that the taxes were being timely filed and paid. He explained, however, that the office manager was a trusted family friend that he thought was properly handling the LLC's taxes. He claims that he did not discover that the taxes were not being paid until after the office manager left in October 2003.

The evidence is not sufficient to establish that Padgett knowingly, and thus willfully, failed to file and pay the LLC's sales tax from September 2000 until he discovered in October 2003 that the taxes were not being paid. Padgett's statement that he had wondered what would happen if he got caught must be viewed in context. He explained that when he made the above statement to the examiner, he meant that he had wondered since he learned about the unpaid taxes in October 2003 what would happen if he was found out. The statement does not prove that Padgett knew before October 2003 that the taxes were not being paid. Consequently, the fraud penalty does not apply for that period. Rather, I agree with the Department's attorney, who stated at the March 1 hearing in response to Padgett's explanation as to why he had failed to pay the taxes – "That sounds to me more like gross negligence, doesn't it, Mr. Padgett." (R. 48)

The fraud penalty does apply, however, to the taxes due after October 2003, which would include the October taxes due on November 20, 2003. As indicated, Padgett assumed the responsibility of filing and paying the LLC's taxes after he discovered in October 2003 that the taxes were not being paid. He thereafter knew that sales tax returns

had to be filed and the tax paid in each month. I understand that he was unsure how to resolve the tax bind he found himself in, but the proper action would have been to notify all authorities of the situation and then at least begin filing sales tax returns for each successive month, even if he could not pay the tax due. He willfully failed to do so.

Also, Padgett's reliance on his office manager to handle the LLC's taxes before October 2003 does not relieve the LLC from liability for the delinquent penalties for that period. As a general rule, an employee's failure to timely file and pay a corporation's taxes does not relieve the corporation from the resulting late penalties. *Atlas Therapy, Inc. v. U.S.*, 66 F.Supp. 1203 (M.D. Ala. 2003); *United States v. Boyle*, 105 S.Ct. 687 (1985).

The above federal cases do not strictly apply because Alabama has a more lenient "good faith" standard for waiving penalties. See, §40-2A-11(h); see also, *Dubose Corporation v. State of Alabama*, S. 05-917 (Admin. Law Div. 3/2/06). However, for the good faith standard to apply, the owner of the business must have had sufficient internal controls in place that would have reasonably assured that the business' taxes were being timely handled. See again, *Dubose Corporation*.

In this case, Padgett had no internal controls or oversight that would have alerted him to the fact that the LLC's taxes were not being filed and paid. The LLC's books were not complicated, and with minimum investigation Padgett could have discovered that the

office manager was not doing her job.¹ Consequently, there is no reasonable cause to waive the late filing and late payment penalties levied at Code of Ala. 1975, §§40-2A-11(a) and (b). The 5 percent negligence penalty at Code of Ala. 1975, §40-2A-11(c) also applies. Those penalties should be assessed for the period September 2000 through September 2003.

The Department is directed to recompute the Taxpayer's liability as indicated above. A Final Order will then be entered.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered April 12, 2006.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: J. Wade Hope, Esq.
John G. Padgett
Myra Houser
Joe Cowen

¹ In contrast, in *Dubose Corporation*, the owner reviewed the corporation's financial status weekly and monthly. An outside CPA firm also conducted an independent annual audit of the corporation's books. The Administrative Law Division and the IRS both determined that under the facts of the case, the corporation had sufficient internal controls in place, and consequently, that the delinquent penalties should be waived.