

Conflicting Standards for Fraud: The State Board of Equalization vs. Itself

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All fraud is not alike, and neither are all of the legal standards applied in proving fraud.

Most civil cases require no more than a preponderance of the evidence to justify a finding of fraud. The slightest unfavorable tilt in the balance of evidence can refute the presumption of innocence.

Income tax cases require a higher standard; to justify a fraud penalty, the IRS must show clear and convincing evidence of wrongdoing, with specific intent to evade the tax. (For purposes of this article, all tax penalties based on a finding of intentional evasion will be referred to as fraud penalties.) Criminal fraud, of course, must be proven beyond a reasonable doubt.

The California State Board of Equalization has refined its distinction even further.

The same SBE that allows its sales and use tax auditors to assert fraud based on a preponderance of the evidence consistently applies the higher standard of "clear and convincing" evidence in income tax cases appealed from the Franchise Tax Board.

In defending its use of the lower standard for sales and use tax cases, the SBE staff cites *Liodas vs. Sabadi* (1977) 19 Cal.3d 278, wherein the court instructed the jury to determine all issues of fraud "by the ordinary civil standard of preponderance of the evidence." This standard is reiterated in Evidence Code Sec. 115, which states, "Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence."

However, *Liodas* was a civil tort case not involving tax fraud. Long-standing case law has established income tax fraud as one of

the exceptions referred to by Evidence Code section 115. In federal income tax matters,

the standard of proof has been clear and convincing evidence for well over half a century. (See, for example, *Vitelli & Son vs. U.S.*, 250 U.S. 355, 39 S.Ct. 544 63 L.Ed. 1028; *Drieborg vs. Commissioner of Internal Revenue*, 255 F.2d 216; and U.S. Tax Court Rule 142(b).) This standard is not statutory; the applicable section of the Internal Revenue Code, IRC Sec. 7454(a), fixes the burden of proof upon the Secretary of the Treasury but does not articulate the standard for that burden.

California income tax cases also require clear and convincing evidence to support a finding of fraud. This standard has been repeatedly affirmed by the SBE in ruling upon appeals from the Franchise Tax Board. In the *Appeal of Alfons Castillo*, No. 92-SBE-020 (July 30, 1992), the SBE stated, "With respect to the civil fraud penalty, the burden of proof is different, for the burden is upon the FTB to prove, by clear and convincing evidence, that the appellant has committed civil fraud."

Like the IRS, the FTB has no statutory standard of proof for establishing fraud. The SBE's own regulation (Title 18, Art. 7, Reg. 5080) closely follows the wording of IRC 7454(a), stating only, "In any proceeding involving the issue of fraud with intent to evade tax, the burden of proof as to that issue shall be upon the Department."

The reasons for requiring a higher standard of proof for civil tax fraud than for private civil fraud seem clear. The naturally adversarial relationship between tax auditors and taxpayers cannot be disregarded, nor can the fact that such relationships may gen-

erate animosity on both sides, creating a tendency for some auditors to "demonize"

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taxpayers. In private civil matters, the opposing parties tend to be on a reasonably equal footing, but the government's almost unilateral power to assert tax and penalties, coupled with its nearly unlimited resources, arguably call for a higher standard to protect the rights of taxpayers. The

interpretation of evidence can be subjective, and where there is little real evidence on either side, declaring a "preponderance" can require nothing more than one auditor's judgment call.

It is significant to note that the SBE held to the "clear and convincing" standard in deciding state income tax appeals well before conformity to federal income tax law became a serious issue. In *Appeal of Bellamy*, 4 SBE 241 (Jan. 8, 1985), the SBE cited and relied upon *Appeal of George W. Fairchild*, SBE, Oct. 27, 1971, wherein the members stated, "The burden of proving fraud is upon respondent, and it must be established by clear and convincing evidence." In *Marchica vs. State Board of Equalization* (1951) 107 Cal.App.2d 501, the only court case on point involving California sales and use tax, the court relied on federal tax cases such as *Vitelli & Sons* and *Drieborg* as the basis for applying the standard of clear and convincing evidence.

For many years after *Marchica*, sales tax auditors avoided asserting fraud penalties except in the most blatant of cases. However, at some point following the *Liodas* decision in 1977, the SBE's sales and use tax department began relying on *Liodas* to support a lowering of the standard. Fraud penalties

started to appear more frequently in sales and use tax audits, and they continued to increase in frequency as more were sustained by the SBE's members. Today such penalties are relatively common in the more aggressive audit districts.

There are at least three distinctions between audits carrying fraud penalties and other audits:

1. Fraud penalties are higher than other penalties;
2. An assertion of civil fraud can lead to criminal fraud charges, although the latter have rarely been attempted and even less frequently sustained;
3. A finding of fraud negates the normal three-year statute of limitations. Auditors are empowered to examine any — and every — period during which a preponderance of the evidence suggests fraud was committed.

The latter distinction is the most important one, especially since taxpayers often do not retain records going back more than a few years. Where an auditor has no more than fragmentary evidence implying fraud, but the taxpayer has even less evidence due to the age of the period under audit, the results can be disastrous. Not only will the tax and penalty apply; the accumulated interest may well exceed both.

Meanwhile, the SBE continues to require clear and convincing evidence when the FTB asserts civil fraud. In the absence of a statutory requirement, the inconsistent treatment of California income tax cases and sales tax cases seems difficult to justify. Not only are different types of taxpayers being treated differently by the same state, they are being treated differently by the same elected board. Until the courts resolve the issue, practitioners must advise their clients accordingly.

