32 T.C. 1090 (1959)

A taxpayer's failure to report illegal income, coupled with attempts to conceal the income, constitutes fraud with intent to evade taxes, justifying penalties.

Summary

The United States Tax Court considered whether Henry and Julia Naples had committed tax fraud by failing to report substantial kickbacks received by Henry. Henry, an employee of B.F. Goodrich, received payments from contractors for work performed at the company's plant. These kickbacks were not reported on the Naples' income tax returns. The court found that the failure to report the income, combined with Henry's attempts to conceal the transactions through fictitious bank accounts, constituted fraud. The court also addressed the failure of the Naples to file declarations of estimated tax, finding that their reliance on an accountant without discussing the issue did not constitute reasonable cause for the omission.

Facts

Henry Naples, an employee of B.F. Goodrich, received kickbacks from contractors who performed work for his employer. He would instruct contractors to inflate their bids to include the kickback amount. He concealed these payments by opening bank accounts under fictitious names and depositing the kickback checks into these accounts. The amounts of unreported kickbacks totaled at least $1,535.82 in 1948, $6,941.03 in 1949, and $26,396.51 in 1950. The Naples did not report these amounts on their joint income tax returns for 1948, 1949, and 1950. Henry consulted with a CPA who did not include the income. Henry and his wife also failed to file declarations of estimated tax for the taxable year 1951.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Naples' income tax and assessed penalties for fraud. The Naples petitioned the United States Tax Court to contest these determinations.

Issue(s)

1. Whether any part of the deficiency for the taxable years 1948, 1949, and 1950 was due to fraud with intent to evade tax, per Section 293(b) of the Internal Revenue Code of 1939.

2. Whether the Naples' failure to file declarations of estimated tax for 1951 was "due to reasonable cause" as defined in Section 294(d)(1)(A) of the 1939 Code.

Holding

1. Yes, because the failure to report substantial kickbacks, coupled with Henry's

efforts to conceal the income, demonstrated an intent to evade taxes.

2. No, because the Naples' reliance on their accountant without discussing the issue did not constitute reasonable cause.

Court's Reasoning

The court found that the Commissioner had met the burden of proving fraud by clear and convincing evidence. The court emphasized that the Naples' failure to report the kickbacks constituted a significant omission, and the use of fictitious bank accounts, printed invoices, and rubber stamps bearing these fictitious names further demonstrated an intent to conceal the income and evade taxes. The court rejected the Naples' arguments that the failure to report the kickbacks was inadvertent. The court stated, "Henry, in the original income tax return filed for each of said years, did not disclose or include in income, any of the kickbacks which he received from contractors in connection with the work which they performed for the Goodrich Company…He is the one who had originated the scheme for such fraud." Concerning the failure to file estimated tax, the court held that the Naples' reliance on their accountant was not reasonable cause because they did not discuss the issue. The court referenced precedent that "'reasonable cause' within the meaning of the applicable statute, is not established by the mere showing that a taxpayer relied generally upon an accountant, without either discussing or obtaining the accountant's advice as to the necessity for filing a declaration of estimated tax."

Practical Implications

This case underscores the importance of reporting all sources of income, including illegal income. Taxpayers cannot escape liability by claiming ignorance or relying on an accountant, especially where the taxpayer attempts to conceal the income. The Naples case is a strong precedent for holding taxpayers accountable when evidence demonstrates active concealment of taxable income. Tax practitioners should advise clients to err on the side of disclosure and document all communication with tax professionals, including discussions about the filing of estimated taxes. The case also reinforces that attempting to conceal income will be seen as strong evidence of fraud and intent to evade taxes.