DAN C. & JERRI C. KING 7532 LUPRE DRIVE MC CALLA, AL 35111-3112,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 09-927
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Dan C. and Jerri C. King (together "Taxpayers") for 2003 and 2004 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on April 1, 2010. Dan C. King (individually "Taxpayer") and the Taxpayers' representatives, attorney Sam McCord and CPA Terry Humphreys, attended the hearing. Assistant Counsel John Breckenridge represented the Department.

The Taxpayer was appointed as circuit judge for the Tenth Judicial Circuit of Alabama in 1997. The Taxpayer ran unopposed and was elected and reelected to the position in 1998 and 2004, respectively.

The Taxpayer testified at the April 1 hearing that when he was appointed to the bench in 1997, he began making personal expenditures for the purpose of influencing his future election to the bench. Specifically, he claimed that he routinely purchased meals at restaurants and food at grocery stores for individuals in his circuit, sponsored basketball games, made donations to various organizations, bought flowers, etc., all for the purpose of getting elected or reelected.

The Taxpayer explained that he kept credit card receipts, check stubs, and other records evidencing the above expenditures, and that he would organize and record the expenditures in a binder every month or two.[1] He then compiled a summary of the expenditures at the end of each year. See, Taxpayers' Ex. 3. According to the Taxpayer, he made the expenditures for essentially public relations purposes, with the specific goal of influencing his future election to the bench. The Taxpayer contends that he spent $161,699.23 from 1997 through 2002 for the above purpose; $15,069.26 in 2003; and $27,361.48 in 2004, for a total of $204,129.97.

In June 2003, the Taxpayer opened a campaign donations bank account with First Financial Bank in the name "Judge Dan King Re-election Campaign." The Taxpayer subsequently deposited various campaign contributions into the campaign account.

During 2003, the Taxpayer converted $76,631 in campaign contributions to his personal use. Specifically, he wrote ten checks totaling $59,540 on the campaign account that were payable to him, personally. He also deposited four campaign contribution checks totaling $6,500 directly into his personal account in that year. And he wrote two checks from his campaign account in the year totaling $10,591.44 that were used to pay personal loans he had with First Financial Bank.

During 2004, the Taxpayer converted $25,115 in campaign contributions to his personal use. Specifically, he transferred $19,415 from his campaign account to his personal account, and also directly deposited three campaign contribution checks

[1] He also entered deductible business-related expenses in the binder related to his job as a judge.

totaling $5,700 into his personal account in the year.

The Taxpayers failed to report the converted campaign donations as income on their 2003 and 2004 State and federal income tax returns. They did claim various itemized deductions on the returns. The Taxpayer testified that concerning his 2003 and 2004 returns, he took his Ex. 3 summary of expenditures during the year to his CPA, who then decided which expenditures on the summary constituted ordinary and necessary business expenses or were otherwise deductible. The Taxpayers subsequently deducted those amounts on the returns for those years. [2]

The Department audited the Taxpayers' 2003 and 2004 returns and determined that the Taxpayers had improperly failed to report the converted campaign contributions as income in those years. It also disallowed various Schedule A itemized deductions claimed on the returns for lack of substantiation. It assessed the Taxpayers accordingly on the unreported income/disallowed deductions. It also assessed the Taxpayers for the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d). This appeal followed.

As indicated, the Taxpayer argues that the Ex. 3 amounts (other than the tax-deductible expenses) he claims he spent buying food, meals, gifts, flowers, etc., for constituents were campaign-related contributions to himself because they were made for the purpose of influencing his future election to the bench. He thus contends that the amounts were "advancements" to his campaign, and that the campaign contributions he subsequently converted to his personal use in 2003 and 2004

[2] The remaining expenditures on Ex. 3 that were not deducted by the Taxpayers are the amounts that the Taxpayer claims were campaign-related expenditures or advancements.

constituted non-taxable reimbursement for those advancements.

The Department asserts in its post-hearing brief that the primary issue is "whether political election (or re-election) expenses are deductible from individual income tax as ordinary trade or business expenses." Memorandum Brief of Department at 1. That is, however, not the issue in this case.[3] Rather, the primary issue is whether the Taxpayers should have reported as income the campaign contributions the Taxpayer admittedly converted to his personal use in the subject years. If so, a second issue is whether the fraud penalty is applicable.

The converted campaign contributions constituted taxable income to the Taxpayers unless they were non-taxable reimbursement for the Ex. 3 expenditures that the Taxpayer claims were campaign advancements he made to himself from 1997 forward. The issue thus turns on whether the Ex. 3 expenses, other than those amounts deducted by the Taxpayers, constituted legitimate campaign advancements or expenditures made by the Taxpayer to further his election to the bench.

The various entries in Ex. 3 show who the amount was paid to, but in most cases there is no specific purpose for the expenditure. Many of the generic entries are for books and magazines. Hundreds involve "food" purchased at fast food and other restaurants and at grocery stores. Others are for YMCA dues, AOL service, sporting

[3]It is undisputed that campaign expenditures made for the purpose of getting elected or re-elected are not deductible. *McDonald v. Comm. of Internal Revenue*, 65 S.Ct. 96 (1944). The evidence shows that the Taxpayers deducted, per their CPA's advice, only those expenses or outlays that constituted ordinary and necessary business expenses required for the Taxpayer to perform his current duties as a judge, or that were otherwise properly deductible. The Department disallowed some of the deductions, but only because the Taxpayers failed to properly substantiate the deductions, not because the types of expenses claimed were per se not deductible.

goods, and flowers, to name only a few.[4] Other than the Taxpayer's general and self-serving testimony that the expenses were campaign-related, there is no evidence indicating the specific purpose for the expenditures. That is, it is impossible to determine whether the various Ex. 3 expenditures were personal in nature or were in some way intended to influence the Taxpayer's election to the bench.

The Taxpayers' CPA testified that he made a random sampling of the Taxpayer's receipts concerning the 2003 Ex. 3 expenditures, and that the receipts verified all expenditures in the sampling. But verification that the expenses were made is not the issue. Rather, the question is the purpose for which the expenditures were made. For example, on August 17, 1997, the Taxpayer spent $222.51 for "supplies." There is no way of knowing whether the supplies were used for personal or business purposes or to somehow influence the Taxpayer's election to the bench. On September 15, 1997, the Taxpayer spent $107.90 at Golden Corral for "food." But again, there is no way to know if the Taxpayer took his family and/or friends out to eat, or whether he took voters in his circuit out to eat for the purpose of influencing his election to the bench.

In short, there is no evidence verifying the Taxpayer's self-serving testimony that the expenditures on Ex. 3 were made for the purpose of influencing his election to the bench. For that reason alone, the Ex. 3 expenditures cannot be found to be campaign-related expenditures by the Taxpayer.

The Taxpayer testified at the April 1 hearing as to why certain of his Ex. 3 expenditures were in furtherance of his election to the bench. Specifically, he testified

[4] Five randomly selected pages from Taxpayers' Ex. 3 are attached and made a part of this Final Order to illustrate the type of expenditures the Taxpayer claims were campaign-related.

about a meeting he had in Gulf Shores concerning how best to handle asbestos cases, trips to the annual State Bar convention, and trips to judges' conferences. He explained that all of the above were in furtherance of his campaign/election as a judge.

The Taxpayer is confusing ordinary and necessary business expenses with campaign expenditures made for the purpose of influencing his election. The expenses incurred in the above activities constituted deductible ordinary and necessary business expenses relating to the Taxpayer's then current job as circuit judge. They were not expenditures in furtherance of his election.

When questioned generally about his purchases from Food World, the Taxpayer explained that many times he "would go buy bottled water to take to the practices for the guys that I was coaching (at his sons' schools) and I still do that today." (T. 65) The definition of "expenditures" in the Fair Campaign Practices Act, at Code of Ala. 1975, §17-5-2(4), is admittedly broad, but it is certainly not so broad as to include buying bottled water for school kids that you are voluntarily coaching. That type of expense is clearly personal in nature. And the fact that the Taxpayer considers buying bottled water for kids he is coaching a legitimate campaign expenditure further calls into question the hundreds of other generic expenses listed in Taxpayers' Ex. 3 that the Taxpayer claims were campaign expenditures.

The Taxpayers' attorney argues in his post-hearing brief at 10, that "as a practical matter anything which a judge may do around a community will affect his election." As indicated, the definition of "expenditures" at §17-5-2(4) is broad, but it certainly was not intended to include "anything" that a judge (or other candidate) may do

around a community. As indicated, Ex. 3 includes hundreds of entries involving expenditures at restaurants. The Taxpayer explained that when he ate lunch or dinner at a restaurant, many times he would eat with a constituent and pay for their meal, or would pay for the meal of a constituent that was otherwise eating at the restaurant. The restaurant expenses listed in Ex. 3, which the Taxpayer claims were campaign expenditures, show a single amount paid, which indicates that the amount also included the Taxpayer's own meal charge. Clearly, the amounts expended by the Taxpayer for his own meals, while they may have been deductible business-related expenditures, were not legitimate campaign expenditures.[5]

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[5] The Taxpayers claim in their post-hearing brief at 6, that "[t]here is nothing in Judge King's testimony to verify that he actually deducted the cost of his lunches." But the Taxpayer's testimony indicates that he included the cost of his own personal meals in the amounts on Ex. 3. When asked if he considered his own meals a campaign expense, the Taxpayer was evasive, and finally objected that the question was for some reason improper.

> The Court: When you would get the bill from Bright Star it would be let's just say for the purposes of this, 30 dollars, lunch for two people, how much would you claim of that as the business expense or the campaign expense?
>
> Taxpayer: Whatever it was, I am sure.
>
> The Court: 30 dollars. Well, wouldn't you have had to eat lunch that day anyway whether you. . . .
>
> Taxpayer: Let me say this to you in response to that question, you know, if you are going somewhere and somebody wants to go with you there to another, you know, to a campaign spot and you eat there at the campaign, you know, you got to eat lunch there, anyway, or you got to eat lunch that day, anyway, so that is not even a – that is not a proper question. I would say this, you know, that would be an improper question.

(T. 78 – 79)

The expenditures also did not qualify as "loans" pursuant to the Fair Practices Campaign Act, Code of Ala. 1975, §17-5-1, et seq. That Act, at Code of Ala. 1975, §17-5-1(6), defines a "loan" as "a transfer of money, property, or anything of value in consideration of a promise or obligation, conditional or not, to repay in whole or in part." The evidence shows, however, that the Taxpayer never expected to be repaid or reimbursed for the Ex. 3 expenditures.

> The Court: Did you start keeping this (journal of expenditures) with the intent of being reimbursed later on for the expenses?
>
> Taxpayer: No, sir, not really. I kept up with it in case somebody, you know, wanted to know.

(T. at 86)

The Taxpayers' representative argues in his post-hearing brief at 7, that the Taxpayer maintained the receipts and summaries of his expenditures after being appointed in 1997 for the specific purpose of later getting reimbursed. That claim is, however, directly disputed by the Taxpayer's above quoted testimony. And when asked why he started keeping a list of his expenditures in 1997, the Taxpayer conceded that he had begun doing so when he started practicing law in 1981.

> The Court: Judge King, you've started keeping records that you compiled into Exhibit 3 back in '97 when you were appointed.
>
> Taxpayer: Yes, sir.
>
> The Court: Why did you do that, why did you keep –
>
> Taxpayer: Well, actually, the same method there I started doing in 1981. This is the same thing, same method I use today that I used back in 1981.

(T. at 84)

The purpose of the Fair Campaign Practices Act, Code of Ala. 1975, §17-5-1 et seq., is to make the financing of elections in Alabama open and transparent to the public. Consequently, the Act requires that all candidates establish a political campaign committee, Code of Ala. 1975, §17-5-4, which must maintain a checking account. Code of Ala. 1975, §17-5-6. All contributions must be deposited into the account, and all expenditures must be made through the account, except expenditures less than $100 may be made from the committee's petty cash fund. Importantly, "[n]o candidate shall expend any money in aid of his or her nomination or election except by contributing to the principle campaign committee. . . ." Section 17-5-4.

It is presumed for purposes of this appeal that the Taxpayer at all times complied with the Fair Campaign Practices Act. Consequently, the Ex. 3 amounts that the Taxpayer claims he spent from 1997 forward to further his election to the bench cannot be considered campaign expenditures because, as indicated, the Act requires that all such expenditures must be made through a campaign bank account. The expenditures in issue were not. And all money expended by a candidate in furtherance of his or her election must first be contributed by the candidate to the campaign committee account. Again, that was not the case. Direct campaign expenditures by a candidate, which the Taxpayer claims he made, are also prohibited.

The Taxpayer also failed to list the amounts as "expenditures" on his annual campaign finance reports filed with the Secretary of State, as required by the Act; nor did he report the amounts as "loans" to his campaign, which is also required by the Act.

He also began making the expenditures in 1997 (or 1981), well before he was a qualified candidate for election to the bench, and also well before he established his campaign bank account in 2003. The above facts, and the fact that the Taxpayer did not expect to be reimbursed for the expenses, indicates that the Taxpayer did not treat or consider the Ex. 3 expenditures as campaign-related when made.

The Taxpayer argues that he did not report the Ex. 3 amounts as loans on his annual reports because the expenditures were "advancements" to his campaign, not "loans" within the purview of the Act. But the terms are in substance interchangeable, and in either case, if the amounts had been campaign-related loans or advancements, they should have been listed on the annual reports. They were not, which again shows that at the time they were made, the Taxpayer did not consider or treat the amounts as campaign expenditures.

In summary, there is no evidence, other than the Taxpayer's self-serving testimony, that the amounts listed in Ex. 3 were made by the Taxpayer for the purpose of influencing his election to the bench. Consequently, they must be treated as personal in nature. The converted campaign contributions thus were not non-taxable reimbursements for prior campaign contributions or expenditures, and thus constituted taxable income received by the Taxpayers in the subject years. The tax due relating to that income is affirmed.

Concerning the disallowed Schedule A deductions, the Taxpayers failed to raise that issue in their notice of appeal. The Taxpayers' representative did, however, argue at the April 1 hearing that the disallowed deductions were also disputed. In any case,

the Taxpayers failed to present any records at the April 1 hearing establishing that the disallowed deductions should be allowed. The burden was on the Taxpayers to do so. *McDonald v. C.I.R.*, 114 F.3d 1194 (1997). The tax due based on the disallowed deductions is also affirmed.

The Department assessed the Taxpayers for the fraud penalty because they failed to report the converted campaign contributions as income on their 2003 and 2004 Alabama returns.

The Alabama civil tax fraud penalty is levied at Code of Ala. 1975, §40-2A-11(d). That statute specifies that "the term 'fraud' shall have the same meaning as ascribed to the term under (the federal tax fraud statute) 26 U.S.C. §6663, ..." If an Alabama tax statute is modeled after a federal tax statute, federal authorities and cases relating to the federal statute should be followed for Alabama purposes. *State, Dept. of Revenue v. Robertson*, 733 So.2d 397 (Ala. Civ. App. 1998); *Best v. State, Dept. of Revenue*, 417 So.2d 197 (Ala. Civ. App. 1981).

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). However, 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 *Traficant 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.").

A key element of fraud is that the taxpayer must act with the intent to mislead or conceal his or her fraudulent activities. For example, an employee that embezzles or otherwise illegally obtains money from his or her employer will normally go to great lengths to hide or conceal the illegal activity, including intentionally not reporting the ill-gotten income on his or her income tax return. In such cases, the taxpayer's knowing failure to report the taxable income is clear evidence of fraud. See, *Howe v. State of Alabama*, Inc. 07-936 (Admin. Law Div. 4/21/2008); *Jockish v. State of Alabama*, Inc. 06-1044 (Admin. Law Div. 4/24/2007).

The Taxpayers admittedly failed to report the converted campaign contributions as income on their Alabama returns for the subject years. But the "mere underreporting of tax is by itself insufficient to establish fraud, unless coupled with other circumstances showing a clear intent to evade tax." *Snoddy v. State of Alabama*, Inc. 05-421 (Admin. Law Div. 12/13/2005), citing *Barragan v. C.I.R.*, 69 F.3d 543 (9th Cir. 1995). Those "other circumstances" are not present in this case.

The Taxpayer openly and admittedly converted the campaign contributions to his personal use. He wrote checks to himself and to his bank from the campaign account, and also deposited campaign contributions directly into his personal account, all activities that left an overt paper trail from which the activities could be easily discovered. He also even "stubbed" or recorded the checks he wrote from the campaign account to himself as "reimbursement" in his campaign account checkbook. See, Taxpayers' Ex. 6. In short, the Taxpayer never attempted to hide the fact that he had converted the campaign contributions to his personal use. That is, there was no attempt to conceal the receipt of the income, and thus no evidence of a knowing and specific attempt to evade tax on the income.

The federal courts have relied on a number of indicators of fraud in deciding federal income tax fraud cases. Those indicia of fraud include (1) a taxpayer's failure to file returns; (2) the failure to report income over an extended period; (3) a taxpayer's failure to maintain and/or provide records; (4) a taxpayer's knowledge of the tax laws; and (5) a taxpayer's concealment of bank records. See generally, *Solomon v. C.I.R.*, 732 F.2d 1459 (6th Cir. 1984).

None of the above indicia of fraud are present in this case. The Taxpayers filed returns for the subject years. They failed to report the income on only two annual returns. There is no evidence that the Taxpayers failed to maintain records, or that they did not readily provide their records to the Department. To the contrary, as discussed, they openly maintained records clearly showing that the campaign contributions had been converted to their personal use. The Taxpayer is a lawyer, but not a tax lawyer.

There is thus no presumption that the Taxpayer has an intimate knowledge of the tax laws. However misguided, the Taxpayer testified that he believed that the converted campaign funds constituted non-taxable reimbursement for his prior campaign expenses. There is no evidence that he knew or believed otherwise. Finally, the Taxpayers did not conceal their bank or other records from the Department.

Under the circumstances, the Department has not established by clear and convincing evidence that the Taxpayers failed to report the converted campaign funds with the knowing intent to evade tax on the income. The five percent negligence penalty at Code of Ala. 1975, §40-2A-11(c) should thus apply, not the fraud penalty.

The final assessments, less the fraud penalty and plus the negligence penalty, are affirmed. Judgment is entered against the Taxpayers for 2003 tax, the negligence penalty, and interest of $6,700.58, and 2004 tax, the negligence penalty, and interest of $2,823.72. Additional interest is also due from the date the final assessments were entered, August 14, 2009.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered February 23, 2011.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
attachment
cc: John J. Breckenridge, Esq.
Samuel R. McCord, Esq.
Tony Griggs