BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFOKNIA

In the Matter of the Appeal of)
)
FRANK L. REYNOLDS)

For Appellant: Henry D. Nunez
Attorney at Law

For Respondent: James C. Stewart
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Frank L. Reynolds for reassessment of jeopardy assessments of personal income tax in the amdunts of $4,763 and $7,909 for the years 1977 and 1978, respectively.

In view of the fact that appellant has admitted that he received income from illegal bookmaking activities during the years in issue, the sole question presented by this appeal is whether respondent properly reconstructed the amount of that income. In order to properly consider this issue, the relevant facts concerning appellant's arrest and the subject jeopardy assessments are set forth below.

On October 31, 1977, Special Agent T. G. Lofgren of the Enforcement and Investigation Branch (EIB) of the California Department of Justice interviewed Barbara Ramirez, a Kings County reserve deputy sheriff, with respect to appellant's suspected bookmaking activities. Deputy Ramirez related to Agent Lofgren the following information: (i) she had been aware of appellant's illegal wagering operation for a year and a half; (ii) appellant accepted illegal wagers from Wednesday through Monday between the hours of 11:00 a.m. and 5:00 p.m., and made collections each Tuesday; and (iii) appellant gave each of his clients three-digit identification numbers for the purpose of placing wagers by telephone. Finally, Deputy Ramirez provided Lofgren with a "spread sheet" she had received from appellant for football games played two weeks earlier. Ramirez told Lofgren that appellant had promised her a percentage of the earnings realized from any clients that she introduced to him.

On November 19, 1977, Ramirez introduced Lofgren to appellant by telephone as a prospective wagerer. During the recorded conversation which ensued, Agent Lofgren placed a $50 wayer with appellant on the outcome of a professional football game. Appellant provided Lofgren with one of the three-digit numbers described above for the purpose of placing future bets. Four days later, Lofgren made another recorded telephone call to appellant and made a $100 wager on the outcome of a football game to be played on November 24; 1977; Agent Lofgren lost both of the described wagers. On November 28, 1977, Lofgren again telephoned appellant and discussed the odds on a football game. After receiving the requested information, an agreement was reached between the two individuals to meet two days later at which time Lofgren would settle his account with appellant.

On November 30, 1977, Lofgren and appellant met as previously arranged; the meeting was conducted under the surveillance of other law enforcement

officials. In addition to paying appellant the $150 due as a result of the aforementioned unsuccessful wagers, Agent Lofgren received from appellant a listing of college and professional football games scheduled for the remainder of 1977; he was also given the "point spreads" for games to be played in the upcoming week. During the course of their meeting, Lofgren was told that future payments could be mailed to appellant's residence. He also related that some of his clients had been transacting business in this manner for over ten years.

The EIB investigation of appellant's bookmaking activities continued until March 8, 1978, the date of appellant's arrest. During the course of this investigation, surveillance was conducted of appellant's activities, additional controlled wagers were transacted, and appellant related to Deputy Ramirez the nature and scope of his operations. On December 23, 1977, Ramirez told Agent Lofgren that appellant had discovered that he was the subject of an investigation in which he suspected Lofgren was involved; appellant subsequently altered his routine but nevertheless continued his illegal enterprise. The record of this appeal reveals that, despite his suspicions regarding Lofgren, appellant cashed a $200 cashier's check sent by Lofgren to cover losing wagers.

On March 8, 1978, Special Agent William K. Stoller of the EIB obtained search warrants for; inter alia, appellant's residence, his vehicle, and an apartment leased to appellant. Among other items recovered during their search, the agents discovered records maintained by appellant of his bookmaking activities over a ten-day period in early 1978. This account revealed that appellant had received $11,440 during the period, and that he had made payments in the amount of $8,840 to successful wagerers. Appellant was arrested upon the conclusion of this search and charged with four counts of bookmaking. He subsequently pled guilty to two counts, and was sentenced to imprisonment for one year.

Upon being notified of appellant's arrest, respondent determined that the circumstances indicated that collection of his personal income tax for the years in issue would be jeopardized by delay. Accordingly, the subject jeopardy assessments were issued on March 9, 1978.

Upon receipt of appellant's petition for reassessment of the subject jeopardy assessments,

respondent, on April 17, 1978, requested that he furnish the information necessary to enable it to accurately compute his income, including income from illegal bookmaking activities. On June 15, 1979, appellant filed returns for both appeal years. For 1977, he reported gross income of $25,926, of which he claimed $20,000 was from "gambing winnings;" $20,614 was reported as his 1978 gross income, of which appellant admitted $15,000 was derived from "gambling." In the course of its review of the documentation submitted by appellant, respondent obtained statements with respect to five of appellant's savings accounts. These statements reveal that appellant made known deposits totaling $44,373.95 in 1977 and $49,937.98 in 1978. After consideration of the above, together with additional material supplied by appellant, respondent denied appellant's petition for reassessment, thereby resulting in this appeal.

Under the California Personal Income Tax Law, taxpayers are required to specifically state the items of their gross income during the taxable year. (Rev. & Tax. Code, § 18401.) As in the federal income tax law, gross income is defined to include "all income from whatever source derived," unless otherwise provided in the law. (Rev. & Tax. Code, § 17071; Int. Rev. Code of 1954, § 61.) Specifically, gross income includes gains derived from illegal activities. (United States v. Sullivan, 274 U.S. 259 [71 L.Ed. 1037] (1927); Farina v. McMahon, 2 Am.Fed.Tax R.2d 5918 (1958).)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. 1.446-1(a)(4); Former Cal. Admin. Code, tit. 18, reg.' 17561, subd. (a)(4), repealed July 25, 1981, Reg. 81, No. 26.) 'In the absence of such records, the taxing agency is authorized to compute a taxpayer's income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17651, subd. (b); Int. Rev. Code of 1954, § 446(b).) The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States,, 226 F.2d 331 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is not required. (Harold E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Rd. of Equal., June 28, 1979.)

In the instant appeal, respondent used the projection method of reconstructing appellant's income from illegal bookmaking. Like any method of reconstructing income, the projection method is somewhat speculative. For example, it may rest on an hypothesis that the amount of income during a base period is representative of the level of income throughout the entire projection period. (Cf. Pizzarello v. United States, 408 F.2d 579 (2d Cir. 1969), cert. den., 396 U.S. 986 [24 L.Ed.2d 4501 (1969).)

It has been recognized that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to insure that such a reconstruction of income does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board require that each element of the reconstruction be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief" that the amount of tax assessed against the taxpayer is due and owing. (United States v. Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr McFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 19-/s.)

Respondent utilized information obtained as a result of the EIB investigation in reconstructing appellant's bookmaking-related income. Specifically, respondent determined that: (i) appellant' had been engaged in his illegal enterprise from at least November 19, 1977, through March 8, 1978, a total of 42 days in 1977 and 67 days in 1978; and (ii) appellant's records revealing $11,440 in gross

income from bookmaking over a ten-day period[1/] in early 1978 were representative of his level of gross income over the entire projection period.

Appellant challenges the subject jeopardy assessments as being arbitrary and erroneous. As set forth above, he maintains that he realized bookmaking-related income of only $20,000 and $15,000 for the years in issue, respectively. After carefully reviewing the record on appeal, we believe that appellant's assertions are untenable and that there exists ample evidence to sustain the subject jeopardy assessments.

Initially, we note that respondent's determination that appellant was engaged in illegal bookmaking from at least November 19, 1977, through March 8, 1978, appears *very* conservative in light of the record of this appeal which reveals that, by his own admission, appellant was engaged in an illegal wagering operation for a substantial period before accepting a wager from Agent Lofgren. In this regard, it is revealing to note that appellant has advanced no objection to respondent's determination as to the length of the projection period. Moreover, we find that respondent's determination that the aforementioned ten-day base period reflects the level of appellant's income from illegal bookmaking activity over the entire projection period is reasonable absent any evidence to the contrary. (Gordon v. Commissioner, 572 F.2d 193 (9th Cir. 1977), cert. den., 435 U.S. 924 [55 L.Ed.2d 517] (1978); Hamilton v. United

1/ As further discussed below, respondent's reconstruction of appellant's gross income from bookmaking was based upon the erroneous conclusion that appellant's aforementioned records reflected a nine-day base period. Accordingly, respondent determined that appellant's average daily gross income from bookmaking totaled $1,271.11, rather than $1,144. Respondent has acknowledged that strict adherence to the reconstruction formula originally employed, when adjusted to reflect this error, would reduce appellant's reconstructed gross income from bookmaking for 1978 from $80,080 to $76,648; appellant's gross income for 1977 would likewise be reduced from $51,480 to $48,048. As discussed later, however, respondent nevertheless maintains that the subject jeopardy assessments should be sustained in their entirety.

States, 309 F.Supp. 468 (S.D.N.Y. 1969), affd., 429 F.2d 427 (2d Cir. 1970), cert. den., 401 U.S. 913 [27 L.Ed.2d 812] (1971).) The mere assertions advanced by appellant are insufficient to show error in respondent's jeopardy assessments. Furthermore, it is relevant to observe that appellant has made no effort to explain why his bookmaking-related income totaled $11,440 for the ten-day base period, when he claims that he earned only $35,000 from his illegal operations over both the appeal years. Finally, the EIB investigative report reveals that appellant's illegal operation remained at the same level of activity throughout the entire projection period, thereby undermining appellant's position that the base period was unrepresentative.

As noted above, strict adherence to respondent's reconstruction formula would reduce the amount of appellant's gross income for each of the appeal years by $3,432 because of respondent's mistaken conclusion that the above-described base period consisted of nine, rather than ten, days. Despite its error, respondent argues that the subject jeopardy assessments should be sustained in their entirety in view of the complete record on appeal which reveals, inter alia, that appellant was engaged in bookmaking long before November 19, 1977, as well as that appellant made known bank deposits in 1978 in excess of $49,000 which, in the absence of evidence to the contrary, should be deemed to constitute additional taxable income to appellant.

The subject jeopardy assessments are based upon all taxable income to appellant during the period in issue, not merely the income reflected in respondent's initial reconstruction thereof. (See Appeal of Philip Marshak, Cal. St. Bd. of Equal.! March 31, 1982.) As we have noted above, respondent's initial determination that appellant was involved in his bookmaking operation from only November 19, 1977, through March 8, 1978, appears too conservative. To earn an additional $3,432 in gross income, appellant would only have had to engage in his bookmaking operation for an additional three days ($11,440 ÷ IO-day base period = $1,144; 3 days x $1,144 = $3,432). By his own admission to Agent Lofgren, appellant had been involved in his activity for over ten years. Moreover, two weeks before the ETB interviewed Deputy Ramirez on October 31, 1977, appellant had provided Ramirez with "spread sheets" needed to wager and had offered her a percentage of the earnings from any clients she introduced to him. In light of this evidence, we find no difficulty in arriving at the

conclusion that appellant was engaged in bookmaking substantially before November 19, 1977, and that he earned at least an additional $3,432 from his illegal operation during that year. With respect to the jeopardy assessment for the year 1978, the fact that appellant continued to make substantial bank deposits long after his arrest, at a time when he had no other known source of income, supports respondent's argument that these deposits represented net wagering income. In previous cases where taxpayers have made substantial bank deposits and have failed to cooperate in the ascertainment of their income, we have upheld respondent's conclusion that those deposits constitute income. (See, e.g., Appeal of Gary and-Lucy Bock, Cal. St. Bd. of Euual., decided this date.) There is no reason to reach a-different conclusion here. Accordingly, we conclude that the record of this appeal supports the 1978 jeopardy assessment in its entirety.

Appellant is not entitled to deduct from his gross income cash payouts made to individuals who placed winning wagers with him. (Rev. & Tax. Code, § 17297; former Cal. Admin. Code, tit. 18, reg. 17297, subd. (b), repealed Jan. 22, 1982, Reg. 81, No. 16.) The enactment of section 17297 demonstrates a clear legislative intent not to allow a deduction for wagering losses from gross income derived from illegal bookmaking activities. (Hetzel v. Franchise Tax Board, 161 Cal.App.2d 224 [326 P.2d 611 (1958).)

For the reasons set forth above, respondent's action in this matter will be sustained.

Appeal of Frank L. Reynolds

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Frank L. Reynolds for reassessment of jeopardy assessments of personal income tax in the amounts of $4,763 and $7,909 for the years 1977 and 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of March, 1983, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Nevins and Mr. Harvey present.

_____, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code Section 7.9