BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THEADORE HALUSHACK)

For Appellant: C. R. E. Smith
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 on the petition of Theadore Halushack for reassessment of a personal income tax jeopardy assessment in the amount of $44,859 for the period January 1, 1981, to October 30, 1981.

Appeal of Theadore Halushack

The issues for determination are the following: (i) did appellant receive unreported income from illegal activities during the appeal period; and (ii) if he did, did respondent properly' reconstruct the amount of that income.

Pursuant to a criminal investigation by the Livermore Police Department and the State Bureau of Crime and Criminal Intelligence, appellant was observed for several weeks. During this investigation, it was learned that appellant picked up betting markers and money from at leastfive retail locations in the Livermore area. Appellant's usual routine was to distribute racing forms and betting markers to customers at these locations in the morning and to return later to pick up the betting markers and money. Appellant's activities were observed and recorded by several government agents. In addition, statements by the owner of one retail establishment indicate that appellant had followed this routine for several years.

Based upon the above observations, Special Agent David Foster was issued a search warrant on October 29, 1981, by the Municipal Court for the County of Alameda for the purpose of searching appellant's residence. The following day, a search of the residence was conducted, and appellant was arrested and charged with bookmaking. Seized at the time of the arrest were numerous racing forms, tally sheets, betting slips and marks. Also seized were a tape recorder and telephone answering machine with 30 cassette tapes. Transcripts from the tapes indicated that appellant accepted wagers over the telephone and at the various retail locations noted above.

Upon being notified of appellant's arrest, respondent determined that the circumstances indicated that collection of his personal income tax for 1981 would be jeopardized by delay. Accordingly, the subject jeopardy assessment was issued. In issuing the jeopardy assessment, respondent relied upon the records and tapes seized at the time of appellant's arrest for purposes of determining appellant's income from bookmaking. An analysis of those records and tapes indicated that appellant accepted average d-aily bets of $1,381.50. This daily average was multiplied by the days in 1981 prior to the arrest (303) to arrive at a taxable income of $418,594.50 for the period at issue. A jeopardy assessment was issued for the resulting tax of $44,859.

Appeal of Theadore Halushack

Appellant filed a -petition with respondent for reassessment contending that he merely picked up wagers from persons and took them to the track in return for a gratuity of approximately $300 per month. Appellant further contends that even if he is considered to be a bookmaker, respondent's assessment is not remoteiy accurate. In reply, respondent contends that appellant's activities constitute bookmaking within the meaning of the California Penal Code and that its reconstruction of his income is reasonable.-

The initial question presented by this appeal is whether appellant received any income from illegal boo'kmaking activities during the year in issue. Re spon- dent may adequately carry its burden of proof through a prima facie showing of illegal activity by the taxpayer. (Hall v. Franchise Tax Board, 244 Cal.App.2d 843 [53 Cal.Rptr. 597] (1966); Appeal of Richard E. and Belle Hummel, Cal. St, Bd. of Equal., March 8, 1976.) Upon reviewing the record on appeal, we are satisfied that respondent has established at least a prime facie case that appellant received unreported income from illegal bookmaking activities during the period under observation. Moreover, the record indicates that appellant had engaged in such activity for several years, covering the entire period under appeal.

The second issue is whether respondent properly reconstructed the amount of appellant's income from illegal bookmaking activities. The California Personal Income Tax Law requires a taxpayer to state specifically the items and amount of his gross income during the tax- able year. Gross income includes all income from whatever source derived unless otherwise provided in the law. (Rev. & Tax. Code, § 17071.) Gross income includes gains derived from illegal activities, including bookmaking, which must be reported on the taxpayer's return. (United States v. Sullivan, 274 U.S. 259 [71 L.Ed. 10371 (1921); 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), repealer filed June 25, 1981 (Register 81, No. 26).) In the absence of such records, the taxing agency is authorized to compute his income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (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. Bd. of Equal., June 28, 1979.)

In the instant appeai, respondent used the projection method to reconstruct appellant's income from illegal bookmaking activities. In short, respondent projected a level of income over a period of time. Because of the difficulty in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of Burr MacFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has also been recognized, however, 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 ensure that use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr MacFarland Lyons, supra,) 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 MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

In the instant appeal, respondent relied upon evidence obtained by the Livermore Police Department and the State Bureau of Crime and Criminal Intelligence in

reconstructing appellant's income at $1,381.52 per day, or $418,594.50 for the appeal period. Specifically, respondent determined, by reference to the transcripts of the telephone tapes of appellant seized at the time of his arrest, that appellant had an average of $458.75 in income for telephone bets per day. Respondent arrived at this figure by determining from the transcripts of such tapes that the average daily telephone bets totaled $834. Estimating that 50 percent of the telephone bets were lost by the callers while the remainder were won, respondent included 55 percent of the total telephone bets,[1/] or $458.75, as income to appellant.[2/] This was based upon the principle that only amounts unsuccessfully wagered by a bookmaker's telephone clientele constitute gross income to him. (Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal., July 29, 1981.) This principle is grounded upon the theory that bookmakers never receive money from successful telephone wagers, and, accordingly, such amounts should not be included in gross income. In addition to these telephone wagers, respondent estimated the number and amount of wagers that appellant physically picked up from various locations to be 100 wagers averaging $10 each, totalling $1,000 per day, which also was to be included in his gross income. Since appellant actually picked up these bets', the Barmach restriction noted above would not be applicable. Since appellant is not entitled to deduct from his gross income cash payments made to individuals who placed winning wagers with him (Rev. &

1/ The 55 percent figure was arrived at by assuming an even break on bets. The 5 percent additional income represents a 10 percent surcharge (vigorish) that bookmakers typically add and which is collected from losing bettors' payments.

2/ Respondent's analysis of the number of losing bets appears to be based only upon a consideration of football wagers rather than race horse wagers. Since it would appear that there would be more lost telephone bets on racing wagers, respondent's conclusions would be conservative and well supported.

Tax. Code, § 17297),[3/] respondent's estimate of taxable income of $1,381.50 would appear to be reasonable in light of its conservative reconstruction of gross income at $1,458.75 (i.e., telephone bets of $458.75 and cash bets of $1,000). Furthermore, since appellant has made no arguments nor presented any evidence indicating that the days of his operation were limited by such factors as the racing season or football season or his income otherwise restricted, we have no choice but to conclude that respondent's action must be sustained.

3/ In pertinent part, Revenue and Taxation Code section 17297, as in effect during the year at issue, provided:

> In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income directly derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, such illegal activities. ...

Appeal of **Theadore** Halushack

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 78595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the petition of **Theadore** Halushack for reassessment of a personal income tax jeopardy assessment in the amount of $44,859 for the period January 1, 1981, to October 30, 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 14th day of November, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

_____, Member