BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SYMBRA'ETTE, INC.)

Appearances:

For Appellant: Jack M. **Wiseman**
Attorney at Law

For Respondent: Brian W. **Toman**
Counsel

O P I N I O N

This appeal is made pursuant to sections 25761a **and 25667** of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of **Symbra'Ette,** Inc., for reassessment of jeopardy assessments of franchise tax in the amounts of **$32,975.14, $41,050.73, $40,255.01, $32,843.07,** and **$31,500.00** for the income years ended September 30, 1970, September 30, 1971, September 30, 1972, September 30, 1973, and September 30, 1974, respectively.

Appeal of Symbra'Ette, Inc.

Appellant Symbra'Ette, Inc. (formerly Ger-Ro-Mar, Inc.) is a manufacturer of brassieres, girdles, lingerie, swimwear and wigs. It employs a multi-level, pyramidal marketing program to sell its products. The details of this program are fully described in the opinion of the United States Court of Appeals in Ger-Ro-Mar, Inc., v. Federal Trade Commission, 518 F.2d 33 (2d Cir. 1975), but for present purposes the following summary will suffice.

In appellant's marketing program, individuals become salespersons or "'consultants" by purchasing at a discount a minimum quantity of appellant's products. For example, individuals entering the system at the lowest level buy products with a retail selling price of $300 for about $215. Along with the merchandise the consultant receives a package of promotional or advertising material, and he also receives an unlimited right to recruit other people into the program. Consultants at all levels of the system may earn a profit by reselling merchandise to the public. A consultant at the higher levels may'also earn various 'commissions, overrides, and other compensation based on sales to his recruits and his recruits' recruits.

On November 24, 1971, the Federal Trade Commission (FTC) issued a complaint charging appellant with several violations of section 5 of the Federal Trade Commission Act. The initial decision of the administrative law judge, dated October 11, 197.3, concluded that appellant's marketing program violated section 5 because, inter alia, the recruitment aspect of the program was "in the nature of a lottery." This determination was based on a finding that participants in the program paid consideration for the "chance" or "gamble" of being able to earn compensation by recruiting other participants. In its final decision, however, the FTC did not adopt the administrative law judge's finding on this point, since it believed appellant's marketing program involved no more of a gamble than many other business enterprises. (In the Matter of Ger-Ro-Mar, Inc., etc., FTC Docket No. 8872, July 23, 1974.) The FTC did issue a cease and desist order against appellant based on other asserted section 5 violations, but the Court of Appeals subsequently reversed the order in part. (Ger-Ro-Mar, Inc. v. Federal Trade Commission, supra.)

On the basis of the litigation between appellant and the FTC, respondent determined that the recruitment aspect of appellant's marketing program constituted an "endless chain" in violation of California Penal Code section 327.[1] Under the authority of Revenue and Taxation Code section 24436,[2] respondent accordingly disallowed all deductions claimed by appellant during the years in question.

The principal issue is whether appellant's marketing plan is an "endless chain" as that term is defined in Penal Code section 327. Under that definition, there are at least three elements to an "endless chain": First, participants in the scheme must pay "valuable consideration"; second, there must be a "chance to receive compensation" for introducing new participants or when certain new participants are introduced; and third, the consideration must be paid "for" that chance. For purposes of this appeal we will assume, without deciding, that the first two elements are present here. The question before us therefore becomes whether, when new consultants enter appellant's marketing system and receive a right to recruit others, do they pay consideration "for" that right?

1/ Penal Code section 327 defines "endless chain" as:

> . . .any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant....

2/ Revenue and Taxation Code section 24436 provides in part:

> In computing net income, no deductions shall be allowed to any taxpayer on any of its 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 [§§ 319-337.9, inclusive]....

In answering this question, it must be kept in mind that the rule regarding the burden of proof in cases arising under Revenue and Taxation Code section 24436 is somewhat different than the rule in most tax cases. **As** we said in the Appeal of Richard E. **Hummel,** etc., decided March 8, 1976:

> Appellants deny the illegality of their activities and contend that it is incumbent upon respondent to establish such illegality in order to prevail. We agree that in cases of this type respondent must make at least an initial showing that appellant's activities were within the purview of [Revenue and Taxation Code] section 17297 [the counterpart of section 24436 under the Personal Income Tax Law] and the provisions of the Penal Code referred to therein....
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> . ..Normally. a presumption of correctness attaches to respondent's deficiency assessments and the burden to prove the incorrectness of those assessments is on the taxpayer; **however,** where the burden is upon respondent to establish the very facts upon which its assessments are based, it cannot rely on the presumption of correctness or mere assertions to evade or shift this burden. [Citation.]
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> Where, as here, respondent seeks to apply a statute as harsh in effect as section 17297 of the Revenue and Taxation Code, we believe it is of particular importance that respondent make an initial showing of illegality.

Respondent relies on the above described finding of the FTC administrative law judge in order to meet its burden of proof. This finding was excluded from the FTC's final decision, however, and is therefore of questionable significance. In any event, the judge's

finding was based on his review of the evidence presented to him, including the testimony of at least one witness. Since thatevidence has not been presented to us for our own evaluation, except insofar as excerpts therefrom appear in the judge's decision, we would be abrogating our responsibility to decide this case if we simply deferred to the opinion of the administrative law judge. Accordingly, we conclude that that opinion, standing alone, is insufficient to establish a prima facie case that participants in appellant's marketing program paid consideration for the chance to earn compensation by recruiting.

Respondent also suggests that marketing programs such as appellant's are per se violations of Penal Code section 327. It seems to argue that since new participants in the program pay money to become consultants, and since they receive a right to recruit, some portion of the money must ipso facto be paid for the right to recruit. As appellant quite correctly points out, this does not necessarily follow. In return for their money, new consultants receive a quantity of merchandise whose retail selling price exceeds the amount they pay, and they also receive a package of promotional material. Since it is possible that the money is paid entirely for the merchandise and promotional material, we cannot conclude that some of the money, as a matter of law, is paid for the right to recruit. The cases relied upon by respondent (People v. Restlfne Products, Inc., 61 Cal. App. 3d 879 [132 Cal. Rptr. 767](1976); People ex rel. Kelly v. Koscot Interplanetary, Inc., 37 Mich. App. 447 [195 N.W. 2d 43](1972)) are not to the contrary, Each of these cases was decided on the basis of evidence presented to the trier of fact. Neither case holds that marketing systems similar to appellant's are per se endless chains.

Finally, respondent argues that it is "hard to believe" that no consideration was paid for the right to recruit. Respondent's burden, however, is to establish at least a prima facie showing of illegality. Considering the harsh effects of Revenue and Taxation

Code section 24436, we do not believe this burden may be met by mere assertions and innuendos. **Rather,** respondent must produce affirmative evidence in support of its allegations. Since that has not been done here, we must reverse **respondent's** action.

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 2.566'7 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of **Symbra'Ette,** Inc., for reassessment of jeopardy **assessments** of franchise tax in the amounts of **$32,975.14, $41,050.73, $40,255.01, $32,843.07,** and **$31,500.00** for the income years ended September **30,** 1970, September 30, 1971, September 30, 1972, September 30,' 1973, and September 30, 1974, respectively, be and the same is **hereby** reversed.

Done at Sacramento, California, this 3rd day of February, 1977, by the State Board of Equalization.

Chairman

, Member

, Member

, Member

Member

ATTEST: W. W. Dunlop, Executive Secretary'