BEFORE THE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82R-2290-AJ
CLIFFORD CLAYDON)

For Appellant: Gary C. Wayland
Certified Public Accountant

For Respondent: philip M. Farley
Counsel

O P I N I O N

This appeal is made pursuant to section 19061.1[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the- claims', of Clifford Claydon for refund of personal income tax plus penalties for the year 1980 in the amount of $1,219.40 and of personal income tax for the year 1381 in the amount of $2,521.00.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

Appeal of Clifford Claydon

The issue in this appeal is whether respondent properly reconstructed the amount of, appellant's unreported income.

Appellant is a 26-year-old man who moved to California from the east coast in late 1979.' He had some experience in the jewelry business and, in January 1930, went to work as a jeweler for one Dal Tucker, In August 1980, Mr. Tucker acquired a location for a second jewelry store and appellant agreed to operate that business. This store was known as Claydon's Jewelers. Apparently, appellant had some partnership interest in that business, but the extent of his interest is not known,

In December 1931, two men were arrested and confessed that they had performed several hundred burglaries during 1930 and 1931. They indicated that appellant was involved, to some extent, in the purchase of stolen property. On January 13, 1982, one of the burglars and an undercover police office-r went to Claydon's Jewelers and sold 14 pieces of jewelry to appellant after informing him that they were stolen. This jewelry was valued by the police at $1,770 and appellant paid $155 for it. Two days later, the police searched Claydon's Jewelers and seized the jewelry sold to him by the undercover officer along with one stolen ring, two guns, and $4,022 in cash. Appellant's arrest followed, and he ultimately pled nolo contendre to one count of attempted receiving of stolen property.

After appellant's arrest, respondent determined that he was involved in the illegal buying and selling of stolen property. Since he had not filed California personal income tax returns for 1930 and 1981, respondent determined that appellant's illegal activities and his operation of Claydon's Jewelers had resulted in unreported income for those years. Respondent issued jeopardy assessments in the amounts of $938 and $2,521 for 1930 and 1981, respectively, and imposed penalties for 1930 for failure to file and negligence. En issuing these jeopardy assessments, respondent used the cash expenditure method to estimate appellant's income for the appeal years. Since the cash seized by respondent exceeds the amounts of the jeopardy assessments-, this appeal is being treated as a denial from claims for refund.

The extent of appellant's criminal involvement is in dispute, and respondent's characterization of that involvement is, in large part, unsupported by the

evidence. Respondent contends that appellant was buying and selling stolen property during 1980 and 1981, and that he was in a criminal partnership involving burglary and fencing with Dal Tucker ("Tucker"), one Penny Carr, and others. A close examination of the record in this appeal has convinced us that appellant was not involved in any criminal partnership with Dal Tucker: that he did not buy or sell stolen items during 1980; and that his criminal involvement, which began in the summer of 1981, consisted only of the following: allowing one Jeff Horwich ("Horwich") to meet burglars and transact illegal business at Claydon's Jewelers; selling some stolen items purchased by Borwich from the burglars; and, on occasion, purchasing stolen items directly from the burglars.

Respondent emphasizes the fact that one of the burglars, in response to a question concerning whether appellant was a friend of Tucker's, answered "[a]ctually Claydon was a friend of Tucker's and Penny's [Penny Carr]. He knew everybody. It was like they all knew, it was like a little ring, each person fit together." (Resp. Br., Ex. G at 33.) Neither this statement nor any other information provided by the burglars indicate that there was a criminal partnership between appellant and Tucker. The burglars stated that, beginning in 1980, Tucker encouraged them to commit burglaries, helped them locate prosperous neighborhoods to burglarize, provided them with a pass key to use to get into homes, and in the beginning purchased virtually all the items they had stolen. (Resp. Br., Ex. G at 7-9.) Although appellant was Tucker's legitimate business partner, the burglars made no mention of him taking any part in the illegal dealings' between Tucker and themselves. Appellant was first mentioned in connection with events which took place in the summer of 1981. At that time, according to the burglars, Horwich began to outbid Tucker for the stolen items and the burglars started selling most of their goods to Borwich. (Resp. Br., Ex. G at 19.) Although respondent contends that Borwich was in partnership with Tucker, it appears that he was actually in competition wit:? him. The burglars stated that while Horwich used to spend time at Tucker's jewelry shop, Tucker threw him out once Horwich started buying from the burglars. (Resp. Br., Ex. G at 19 & 20.) In addition, the burglars stated that when Horwich would not give them their desired price for a piece of jewelry, they would attempt to sell it to Penny Carr, who was working with Tucker. (Resp. Br., Ex. G at 45.) Borwich met the burglars and transacted his business at Claydon's Jewelers. (Resp. Br., Ex. G at 30-32.) Although

appellant allowed them to do so, the burglars specified that appellant was not directly involved in the purchasing of the stolen items and that they never discussed the fact that the items were stolen in front of him, (Resp. Br., Ex. G at 32, 35, 38, & 40.) The burglars did say that they had sold one item to appellant, but. indicated that there had been no discussion concerning whether or not this item was stolen.. (Resp. Br., Ex. G at 32.) The burglars also indicated that they suspected appellant of selling stolen jewelry because they thought that items they sold to Horwich later appeared for sale at. appellant's store. (Resp. Br., Ex. G at 37 & 38.)

Respondent also contends that appellant's criminal partnership with Tucker is proved by certain records found in appellant's store. These records list prices to be paid for jewelry based upon the price that a certain smelter with which Tucker dealt would pay to "us." Respondent contends that the "us" refers to the criminal partnership between appellant and Tucker. However, appellant was involved in a legitimate business partnership with Tucker and the records could just as easily refer to the legitimate business partnership. Similarly, standing alone, the mere purchase of jewelry to sell to a smelter does. not necessarily lead to the conclusion that stolen jewelry is being purchased,

Finally, respondent alleges that appellant's criminal involvement is established by the fact that at the time of his arrest, appellant possessed "[n]umerous items of jewelry, some readily identifiable as stolen." (Resp. Br. at 4.) Actually, of the jewelry seized, only one piece, a school ring, was identified as having been stolen. The rest of the jewelry seized was the jewelry appellant purchased from the undercover officer. Therefore, this merely confirms that appellant purchased, items he believed to be stolen on one occasion, January 1'3, 1982, which was in a period not covered by the assessments in issue. It does not establish that appellant was involved in the purchase of stolen items prior to that date.

In conclusion, we believe that respondent's determinations that appellant was in a criminal partnership with Tucker and that appellant was involved in illegal activity during 1980 are not supported by the record. There is, however, some support in the record for the determination that, during the last half of 1981, appellant was at least minimally involved in criminal activity with Horwich. With these conclusions in mind,

we will examine the jeopardy assessments for 1980 and 1981 to determine whether they can be sustained.

The California Personal Income Tax Law requires a taxpayer to state specifically the items and amount of his gross income during the taxable year. Gross income includes all income from whatever source derived unless otherwise provided in the law. (Rev, & Tax. Code, § 17071.) Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. 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. The existence of unreported income may be demonstrated by any practical method of proof that is available. Mathematical exactness is not required. Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (See Appeal of Fred Dale Stegman, Cal. St, Bd. of Equal., Jan, 8, 1985, and cases cited therein,)

In this appeal, respondent used the cash expenditure method of reconstructing income, a variation of the net worth method. Both of these methods are used to indirectly prove the receipt of unreported taxable income. The net worth method involves ascertaining a taxpayer's net worth at the beginning and end of a tax period. If a taxpayer's net worth has increased during that period., the taxpayer's nondeductible expenditures, including living expenses, are added to the increase and if that amount cannot be accounted for by his reported income plus his nontaxable income, it is assumed to represent unreported taxable income. The cash expenditure method may be used when the taxpayer spends the unreported income instead of accumulating it, In such a case, the government estimates unreported taxable income by ascertaining what portion of the money spent during the tax period is not attributable to resources on hand at the beginning of the tax period, nontaxable receipts, and reported income received during that period. (See Holland v. United States, 348 U.S. 121 [99 L.Ed. 150] (1954); Taglianetti v. United States, 398 F.2d 558 (1st Cir. 1968).)

The first step in applying both the net worth and the cash expenditure methods is the determination of the taxpayer's opening net worth, (See Appeal of Fred Dale Stegman,. supra, and cases cited therein,) However, the type of evidence needed to establish the opening net worth may differ according to which method of reconstruc-

ting income is involved. In the typical net worth case, the taxing agency would nave to determine precise figures representing the taxpayer's opening and closing net worth, whereas the cash expenditure method does not require such a formal presentation. The cash expenditure method merely requires that there be some proof which "makes clear the extent of any contribution which beginning resources or a diminution of resources over time could have made to expenditures." (Taglianetti v. United States, supra, 398 F.2d at 565.)

In the instant appeal, respondent determined that appellant'had no resources at the beginning of the appeal years which could have contributed to iris expenditures during those years. We believe that respondent has. presented adequate proof to support this assumption. Appellant's age and employment history prior to 1980 make it unlikely that he could have accumulated a substantial amount of money. Appellant was 26 in 1980. For the two years prior to moving to California, he worked as a jeweler, earning $6 per hour. In 1979, he reported wages of $12,304 on his personal income tax return and reported no interest or dividends. Appellant filed no California personal income tax returns for 1980 and 1981. He contends that in 1980 he lived on the proceeds from the sale of a 1969 Jaguar which he had purchased with money received in settlement of a lawsuit. However, he produced no evidence to substantiate this claim, Therefore, he has failed to prove that respondent's assumption was incorrect, and it is reasonable to find that he had no 'assets in the beginning of 1980 and that the expenditures he made during the appeal years were made with income earned during those years. This is particularly true in light of the fact that appellant obviously had a source of income, the jewelry store, and reported no income for those years. ,

Our determination that appellant was not involved in illegal activity during 1980 does not lead to the conclusion that the 1980 jeopardy assessment was incorrect, since the cash expenditure method is not applicable only when there is illegal activity. (See Buckner v. Commissioner, ¶ 64,147 T.C.M. (P-H) (1964).) It is acknowledged that appellant had a legitimate business, the jewelry store, and yet filed no tax return for 1980. This gives rise to the suspicion that appellant had unreported taxable income in 1980.

Respondent estimated appellant's monthly expenditures for the year 1980 to include $1,000 Living

expenses: $300 business rental payments; and $300 business utility payments for a total of $1,600 per month or $19,200 per year. Respondent thus concluded that appellant had taxable income of $19,200 in 1980. Initially, respondent produced no evidence supporting its assumption that appellant's monthly living expenses equaled $1,000 and asked this. board to find that such amount was reasonable on its face. We need not address the is-sue of whether such a finding can be made without any evidence, since, appellant later admitted to having annual living expenses of approximately $12,000. Thus, these expenses were correctly included in appellant's expenditures, The business expenses of $600 per month should not *have* been included in appellant's expenditures since these, presumably, were deductible as ordinary and necessary business expenses. In determining the taxpayer's expenditures, only nondeductible expenses are considered, (Hoffman v. Commissioner, ¶ 60,160 T.C.M. (P-H) (1960), aff'd., 298 F.2d 784 (3d Cir, 1962).) Since the only expenses which should have been considered were appellant's living expenses, which equaled $12,000, the amount determined to be appellant's unreported income for 1980 must be reduced to $12,000. Appellant has presented no argument concerning the imposition of the penalties for 1980, Therefore, we must conclude that they were properly imposed.

Respondent determined appellant's 1981 expenditures by including: $1,000 per month for living expenses; the $4,022 cash seized when appellant was arrested; two guns which were seized valued at $500; other guns which were not seized valued at $4,300; and jewelry seized valued at $10,000. Respondent has agreed to remove the value assigned to the guns which were not seized, since it did not have evidence supporting the value of $4,300 assigned to these items. The inclusion of $1,000 living expenses was correct, since appellant admitted that. Respondent did present evidence that the police valued the guns seized at $500, and appellant did not prove that he paid less for these items than their value, Therefore, respondent correctly included that amount in appellant's expenditures. Respondent also included $10,000 as representing the value of the jewelry seized. However, with the exception of a man's lo-karat gold school ring, which is apparently of minimal value, all the jewelry seized was sold to appellant by the undercover officer. The record indicates that the jewelry was worth less than $2,000 and that appellant paid only $155 for this jewelry. (Resp. Br., Ex. C at 1 & 4 and Ex. E at 2.) Therefore, only $755 should

have been included in appellant's expenditures. Finally, the cash seized was properly included. Although appellant contends that $3,000 of this cash was a deposit from a customer, he presented no evidence to support this, and no one has come forward to claim the money. Therefore, it is reasonable to conclude that the money belonged to appellant. The total of the cash and expenditures is $16,677. Since we have found that appellant had no assets at the beginning of 1980 and that his income matched his expenditures in 1980, it is reasonable to assume that the $16,677 was earned in 1981.

After *applying* the cash expenditure method, respondent reviewed various business records belonging to appellant and estimated his business income for 1981 at $15,813.41. In order to arrive at appellant's unreported income for 1981, respondent added that amount to the amount determined to be income under the cash expenditure method. Thus, respondent used both the cash expenditure method and appellant's business records to determine his income during the same period. The application of the cash expenditure method estimates appellant's total income during the period in question. Therefore, it is clearly impermissable to add an estimate of his business income to the amount determined using the cash expenditure method, since to do so would result in appellant being taxed twice on the same income. (See United States v. Caserta, 199 F.2d 905, 907-908 (3d Cir. 1952).)

Respondent advances an alternative theory, which it contends is applicable and establishes the correctness of both proposed assessments in their entirety. Respondent contends that appellant was in a criminal partnership with Dal Tucker, who with others, received nearly $200,000 in exchange for smeltered metal and that appellant can be taxed on the entire income earned by the partnership. Although a taxing agency may have the authority to charge one partner with the entire income earned by the partnership (Miller v. Commissioner, ¶ 81,249 T.C.M. (P-H) (1981)), respondent's theory must be rejected, since as discussed above, the record in this appeal contains no evidence that appellant was involved in an illegal partnership with Tucker.

For the foregoing reasons, we conclude that respondent erred in reconstructing appellant's taxable income,' and that the amount of -income must be reduced to $12,000 and $16,677 for 1980 and 1981, respectively. The penalties imposed for 1980 must be reduced accordingly. Respondent's action must, therefore, be modified-

Appeal of Clifford Claydon

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Clifford Claydon for refund of personal income tax plus penalties for the year 1980 in the amount of $1,219.40 and of personal income tax for the year 1981 in the amount of $2,521.00, be and the same is hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 19th day Of November , 1986, by the State Board of Equalization, with Board Members Mr. Nevins,Mr.Collis,Mr.Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Benentt , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) 82R-2290-AJ
Clifford Claydon)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed February 9, 1987, by the Franchise Tax Board for rehearing of appellant's appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of November 19, 1986, be and the same is hereby affirmed.

Done at Sacramento, California this 28th day of July, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis, per Government Code.section 7.9