BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 84-SBE-133-KP
JEFFREY S. HORWICH	)	

For Appellant: William K. Shipley
Attorney at Law

For Respondent: Philip M. Farley
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Jeffrey S. Horwich for reassessment of a jeopardy assessment of personal income tax in the amount of $15,578 for the year 1981.

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

The issue presented by this appeal is whether respondent's reconstruction of appellant's income is supported by the record on appeal.

On November 10, 1981, an individual named Allen Lepley was arrested for burglary by the Las Angeles Sheriff's Department. A month later, Lepley and his burglary partner, John Gray, confessed that since January 1981, they had perp2trate.d several hundred burglaries in southern Los Angeles County. During their admissions, the two burglars stated that they had sold some of the jewelry and guns they stole to appellant, a dental. student enrolled in the University of Southern California. In addition, the burglars implicated two independent jewelers named Clifford Claydon and Dal Tucker, and several other parties as being, buyers of their stolen property. Both criminals agreed to cooperate with an investigation of those individuals to wham they had sold stolen goods.

On January 13, 1982, Gray and an undercover sheriff's officer sold appellant a stolen video tape recorder. On January 15, 1982, the sheriff's department obtained and executed a search warrant for appellant's residence. Among the items confiscated by the investigating officers were several pistols,- many pieces of jewelry, gold, and Loose precious stones, and several sets of records pertaining to the buying and selling of jewelry. Eventually, appellant pled quiltyto one count of receiving stolen property, a pistol, and was sentenced to Eive years probation.

Soon after appellant's residence was searched, respondent was informed of the above discoveries and determined that appellant had received unreported income from the buying and selling of stolen property. Respondent also determined that the collection of tax would be jeopardized by delay. Respondent estimated appellant's income for 1981 by the use of the cash expenditure method of income, reconstruction. First, respondent assumed that all of the jewelry found durinq the search was stolen and had been purchased by appellant for "fair market value," a value estimated by respondent. Next, respondent interpreted some of the records found during the search as indicating that appellant had loaned his father and his sister each over $10,000. Lastly, respondent determined that appellant had iiving expenses of $1,000 per month. As respondent determined that appellant did not have the known resources to conduct these transactions, it determined that all of the above-described expenditures

represented income earned in 1981 from 'his illegal business of buying and selling stolen property. Respondent totaled all of the listed expenditures to arrive at its income estimation and issued the appropriate assessment.

Subsequently, appellant filed a petition for reassessment. In the course of his protest, appellant produced evidence that although some of the guns found during the search were stolen property, much of the confiscated jewelry was owned by other parties and that appellant was simply storing the items in his floor safe. Further, appellant claimed that he received over $20,000 in loans from his relatives, Appellant also stated that he was living with his parents where he was not required to pay for room or board, Therefore, respondent's estimation of living expenses was far in excess of appellant's true expenses. Finally, appellant produced evidence of $13,000 in student loans that he took out to help him through dental school. Appellant contended that these loans plus the loans from his-family accounted for his living expenses for 1981 as well as the funds with which he bought the few confiscated items discovered to be stolen. Appellant claimed that he did not earn more than $5,000 in adjusted gross income, and, therefore, was not required to file a tax return for 1981. Finally, appellant took issue with the fact that respondent issued a jeopardy assessment before the time for filing a return for 1981 had expired.

Respondent rejected appellant's explanation as to his income, determining that even if the confiscated. items were not stolen, appellant still had vast amounts of income from his participation in an alleged "fencing" partnership. Consequently, respondent denied appellant's petition and this appeal followed.

Under the California Personal Income Tax Law, a taxpayer is required to state the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) Except as otherwise provided by law, gross income is defined to include "all income from whatever source derived" (Rev. & Tax. Code, § 17071), and it is. well established that any gain from the sale of stolen property constitutes gross income. (Appeal of Kenneth E. Sayne, Cal. St. Bd. of Equal:, May 4, 1983.)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return, and 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, § 17561; I.R.C. § 446.) Where a taxpayer fails to maintain the proper records, an approximation of net income is justified even if the calculation is not exact. (Appeal of Siroos Ghazali, Cal. St. Bd. of Equal., Apr. 9, 1985.) Furthermore, the existence of unreported income may be demonstrated by any practical method of proof that is available and it is the taxpayer's burden to prove that a reasonable reconstruction of income is erroneous. (Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.) If, however, the reconstruction is found to be based on assumptions lacking corroboration in the record, the assessment is deemed arbitrary and unreasonable, (Shades Ridge Holding Co., Inc. v. Commissioner, ¶ 64,375 T.C.M. (P-H) (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966).) In such instance the reviewing authority may redetermine the taxpayer's income on the facts adduced from the record- (Mitchell v. Commissioner, 416 F.2d 101 (7th Cir, 1969); Whitten v. Commissioner, ¶ 80,245 T.C.M. (P-H) (1980); Appeal of David Leon Rose, Cal. St. Bd. of Equal., Mar'. 8, 1976.)

The first question presented by this appeal is whether appellant was involved in the buying and selling of stolen property. Respondent may adequately carry its burden of proof that a taxpayer received unreported income through a prima facie *showing* of illegal activity by the taxpayer- (Ball v. Franchise Tax Board, 244 Cal.App.2d 843 (53 Cal.Rptr. 597] (1966); Appeal of Bee Yang Juhang, Cal. St. Bd. of Equal., Nov. 6, 1985.) Evidence contained in police reports, even though it is hearsay evidence, may be considered by this hoard as it is the sort of evidence on which responsible persons are accustomed to rely in the conduct of serious. affairs, (Appeal of Carl E. Adams, Cal. St. Bd. of Equal., War. 1, 1983.) Respondent's conclusion that appellant was a "fence" was based upon his plea wherein he admitted 'that he purchased a stolen pistol and upon statements in a police report by the two burglars that appellant had purchased stolen property from them 30-35 times in the six months prior to their arrests. They also stated that some of the jewelry purchased by appellant subsequently appeared in the showcases of the Claydon Jewelry store. Appellant has not produced any evidence to explain or contradict this evidence. Accordingly, coupling these facts with the discovery of stolen goods in appellant's residence, we find that respondent has established that appellant was involved with the buying and selling of

stolen property and that he made some income from those efforts.

The next issue is whether respondent properly reconstructed the amount of income appellant received from the illegal buying and selling of stolen goods. To arrive at its estimate of income, 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. (Appeal of Fred Dale Steqman, Cal. St. Bd. of Equal., Jan. 8, 1985.) The net worth method involves ascertaining a taxpayer's net worth at the beqinninq 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 nis nontaxable income, it is assumed to represent unreported taxable income. The cash expenditure method may be used when the taxpayer spends unreported income rather than accumulating it. (Appeal of Fred Dale Steqman, supra.) In such a case, the government estimates unreported taxable income by ascertaining what portion of the money spent during the tax period is not attributabie to resources on hand at the beginning of the period, to nontaxable receipts, and to 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 use of the net worth method and the cash expenditure method has been approved by the United States Supreme Court. (Holland v. United States, supra; United States v. Johnson, 319 U.S. 503 [87 L.Ed. 1546] (1943).) In Holland, a criminal action involving the net worth method, the court, recognizing that the use af that method placed the taxpayer at a distinct disadvantage, established certain safeguards to minimize the danger for the innocent. One of these is the requirement that the government establish "with reasonable certainty . .. an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets." (Holland v. United States, supra, 348 U.S. at ,132.) The holding of Holland has been extended to cases 'involving the cash expenditure method. (Dupree v. United States, 218 F.2d 781 (5th. Cir. 1955).) It has also been held to apply to civil cases in which the burden of proof is on the taxpayer rather than the government. (Thomas v. Commissioner, 223 F.2d 83, 96 (6th Cir. 1955).) In

such cases, the burden of proof remains on the taxpayer, but the record must contain at least 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.) If such proof is lacking, the government's determinations are arbitrary and cannot be sustained. (Taglianetti v. United States, supra; Thomas v. Commissioner, supra.)

Neither party has provided us with a specific opening net worth for 1981. As respondent has used the cash expenditure method of income reconstruction, however, the need to establish a specific opening net worth dollar 'amount is diminished, (Taglianetti v. United States, supra.) If the circumstances of an appeal provide a basis for determining a reasonable approximation of an opening net worth, we will uphold its validity. (See Appeal of Dennis and Cynthia Arnold, Cal. St. Bd. of Equal., May 6, 1986, fn. 2.)

Appellant was a dental student at an expensive private school. He had apparently been a student for a number of years. His only known employment in the three years prior to 1981 consisted of part-time work which did not pay him more than $2,300 a year. His only known asset was a 7971 Porsche.. Furthermore, appellant apparently took out several student loans to pay tuition and, presumably, some of his living expenses. The fact that he had very few assets, that he had little known income prior to 1981, and that he had to borrow for his education, thereby indicating that he had little in cash reserves, supports a conclusion that appellant's 1981 opening net worth was negligible. Consequently, we find that appellant had a minimal opening net worth and any expenditures that can be credited to appellant for 1981 must have come from income received during that year. (See Appeal of Dennis and Cynthia Arnold, supra,.)

We turn.to the question of which af the alleged. expenditures may be credited to appellant. Respondent reviewed appellant's records seized in the search of his residence and determined that notations below his sister's and father's names evidenced loans or gifts made by appellant to his relatives. Appellant disputes this contention.

In support of his position, appellant argues that respondent has misinterpreted his records and points to a separate sheet of paper in the seized records

entitled "Money Out," under which he wrote "500 to Dad." (Resp. Br., Ex. F at 23.) The contention is that if appellant had paid money to his father and sister, those payments would have been recorded on that page. We also note that the page recording amounts under the names of his relatives is located a number of pages removed from the "Money Out" page. Furthermore, respondent has not provided us with any evidence, other than its interpretation of the records, to support is position, In light of the extensive records kept by appellant, including the one page marked "Money Out," and the lack of evidence supporting respondent's position, we find that respondent incorrectly interpreted appellant's records as indicating that appellant loaned money to his relatives. Therefore, as respondent has failed to prove those alleged expenditures existed, it has failed. to prove that they represented unreported taxable income to appellant-

We now turn to respondent's determination that appellant had $1,000' a month in living expenses.. Rather than producing evidence of these alleged living expenses, respondent simply relies on the Appeal of Kenneth E. Sayne, supra, wherein we found that living expenses for a single male in 1978 of over $1,000 a month was 2 reasonable amount. Respondent's interpretation of that case is rather liberal. In the Appeal of Kenneth E. Supra, we stated that a careful review of the record supported a conclusion that "each of the elements of respondent's reconstruction formula is reasonable," Consequently, there was a factual basis in the record to support respondent's determination. While we agree that respondent may, in the proper circumstance, estimate living expenses , there must be some basis for that determination. (See Giddio v. Commissioner, 54 T.C. 1530 (1970), wherein the court approved an estimation of living expenses based upon the Bureau of Labor Statistics tables; see also Denson v. Commissioner, ¶ 82,360 T.C.M. (P-H) (1982).) There is no such basis in this appeal, Furthermore, even if we were to find that $1,000 a month was a reasonable amount of living expenses for a single male in 1981, those expenses would necessarily include room and board, items that appellant was nut required to pay while living with his parents. An estimation of expenses that does not take into account- a taxpayer's circumstances is clearly arbitrary. (See Taglianetti v. United States, supra.)

> [Where] it is apparent from the record that ... [respondent's] determination is arbitrary and

> excessive, the taxpayer is not required to establish the correct amount that lawfully might be charged against him, and 'he is not required to pay a tax that he obviously does not owe.

(Durkee v. Commissioner, 162 F.2d 184, 187 (6th Cir. 1947).)

Consequently, we find that respondent's estimation of appellant's living expenses is not supported by the record, and is, therefore, arbitrary and must be excluded in its entirety from a reconstruction of his income.

We note, however, that appellant was a student at the University of Southern California School of Dentistry, an expensive private university. As a student, appellant was required to pay tuition, purchase books, and buy other necessary supplies for his dental school. These necessary expenditures for 1981 were approximately $10,700. Accordingly, it is reasonable to assume that appellant made these expenditures and that they came out of current receipts, either taxable or nontaxable, for 1981.

The last series of expenditures in question involve the jewelry found in appellant's safe. Respondent assumed all of the jewelry had been purchased by appellant and assigned a value of $120,000 to the lot. This assumption was supported by the fact that one item of jewelry, several handguns, and a television set were all identified as stolen property.

Appellant disputes respondent's determination by contending that most of the jewelry belonged to others who were storing their goods in his safe. In support of his position, appellant has submitted a copy of an appraisal Letter dated 1979 which identifies many of the jewelry items found in the safe as being owned by his sister. Furthermore, appellant's records and a letter from Morando Jewels indicate that he was selling some items of jewelry on consignment for that store. Apparently, many of the items impounded by the sheriff's office were consignment items from Morando's; appellant has submitted a letter dated 10 days after his arrest wherein Morando Jewels requested that the sheriff's office release specific items of jewelry as Morando's was the rightful owner. Consequently, we find that appellant has proven that these two groups of jewels were not

purchased by appellant and, therefore, were improperly included in respondent's estimation of income.

The above finding does not account for all of the items seized. First, to account for the balance of the jewelry, appellant states that some of the seized jewels and gold were purchased by him for his legitimate jewelry setting business. His records support this contention and indicate that he bought those items in 1981, prior to his arrest. Second, at least one bracelet was stolen property, as were six pistols and the television set. As statements made by the burglars indicate that they immediately sold the goods they stole, we may assume that all of the stolen items had been purchased by appellant in 1981, the year of their theft. As we have determined that appellant's net worth at the beginning of 1981 was essentially zero, we may assume that all of these purchases represent income he received during 1981.

The next question is how much income the purchases represent. Respondent assigned a value to the jewelry which it determined to be the fair market value. We do not find respondent's determination valid. As stated above, the cash expenditure method of income reconstruction requires that respondent look to the amount actually paid by the taxpayer, not the fair market value of the item. (See Taglianetti v. United States, supra.) First, in regards to the jewels and gold appellant purchased for his jewelry setting business, appellant kept careful records of what he paid for the items. As these records were prepared prior to his arrest and have not been impeached by any evidence offered by respondent, we find the records convincing as to the actual price paid by appellant, a total of $17,774, Second, we have already established that appellant was, to some degree, involved with the buying and selling of stolen property. According. to the burglars, appellant was purchasing items from them at extremely low prices, e.g., pistols commonly sold for $100 each. Consequently, we find that appellant received further income in 1987 in the amount he paid for the six pistols, the bracelet, and the television set.

As we have established that appellant received over $28,000 in income during 1981, we must now consider how much of that income came from taxable sources- Appellant has provided us with documentation proving his receipt of $13,000 in student loans, a nontaxable source

of funds. Appellant has further provided us with statements from his sister and father alleging that they Loaned him over $20,000 that year. If these statements are accepted as true, the nontaxable cash appellant received in 1981 would more than account for all of the known expenditures made by him.

We note, however, that because of the special relationshio enjoyed by related parties, transactions between family members require special scrutiny. (See Harris v. Commissioner, ¶ 73,150 T.C.M. (P-H)(1973); Appeal of Israel and Lilyan Stavis, Cal, St. Bd. of Equal., May 4, 1983; Appeal of Harry and Peggy Groman, Cal. St. Ed. of Equal., Dec. 7, 1982.) Unsupported statements do not satisfy a taxpayer's burden of proving that loans between family members exist. (Appeal f Georgia Cassebarth, Cal. St. Bd. of Equal., Feb. 4, 1986; Appeal of Israel and Lilyan Stavis, supra; Appeal of Harry and Peggy Groman, supra.) Appellant has only provided sworn statements that the loans existed and has relayed the relatives' indignation that those statements are not sufficient to prove that the loans were in fact given. No matter how indignant the lenders may be, their protests are only unsupported allegations, Appellant was gi-ven ample opportunity to produce some documentation, such as cancelled checks or promissory notes, to prove the existence and amounts of those loans.As he did not, we find that appellant has failed to prove that he received an additional $20,000 in nontaxable income during 1981.

In summary, we find that appellant had over $28,000 in expenses for 1981 while receiving only $13,000 in nontaxable income. Consequently, the difference between the nontaxable income and the known expenditures may be assumed to be unreported taxable income.. (Appeal of Fred Dale Stegman, supra.)

Respondent has attempted to redeem its full assessment through the use of a partnership theory. Respondent argues that appellant, Dal Tucker,- Clifford Claydon, and several others were part of a large-scale "ring" trafficking in stolen goods. Respondent contends that any one member of a partnership may be held responsible far the profits of the partnership as a whole. Therefore, as the "partnership" allegedly made over $200,300 during 1981, by assigning that profit to appellant, respondent's assessment is more than adequately supported_

We need not consider respondent's last assertion or determine the alleged profits from this "partnership." We find that respondent has failed to produce any evidence to establish that such a criminal partnership existed. While all of the parties named by the burglars did know each other, there is nothing to connect them as partners. Rather, it is clear from the record that appellant was in competition with Tucker, the central figure of the alleged ring. The burglars themselves stated that appellant used to buy goods at Tucker's jewelry store by outbidding Tucker and others. (Resp. Br., 2x. P at 20.) Furthermore, the burglars stated that after one sale of goods to Tucker, appellant allegedly stated that the burglars were being taken advantage of at Tucker's, and that he would pay a better price. (Resp. Br., Ex. P at 19.) Appellant told; them to meet him at Claydon's store where he would buy ail of their goods. (Resp. Br., Ex,. P at 20.)These actions resulted in Tucker forbidding appellant from buying at his store. (Resp. Br., Ex, P at 20). Furthermore, once appellant began to buy at Claydon's store, the record makes it obvious that Claydon attempted to distance himself from the buying and selling of stolen goods. (Resp. Br., Ex. P at 30-35.) Finally, a contextual reading of the supposed damning statement made by the burglars that "it was like a little ring, each person fit together," reveals the simple truth that the parties knew each other. (Resp. Br., Ex. P at 33.) The record does not indicate that they were all part of a "fencing ring," (See Resp. Rr., Ex. P at 33.) Consequently, we find that respondent has failed to prove that appellant was a member of a partnership which dealt in stolen property, Accordingly, respondent cannot use the alleged "partnership" profits to prop up its assessment,

Finally, appellant takes issue with respondent's issuance of a jeopardy assessment, contending that as there was still time left for appellant to file his 1981 tax return, the collection of his tax was not in jeopardy. We need not address this contention. Respondent's authority to issue jeopardy assessments is conferred by section 18641, and its decision to is'sue the jeopardy assessment for the appeal year is not subject to review by this board.. (Appeal of Karen Tomka, Cal. St. Bd. of Equal., May 19, 1951; Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) our only consideration on appeal is the propriety of the deficiency actually determined by respandent for the period of assessment, (Appeal of

Karen Tomka, supra; Appeal of John and Codelle Perez, supra.)

For the above-stated reasons, respondent's assessment must be modified to reflect as income for 1981 only those known expenditures that cannot be accounted for by appellant's nontaxable receipts'.

Appeal of Jeffrey S. Horwich

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 Jeffrey S. Horwich for reassessment of a jeopardy assessment of personal. income tax in the amount of $15,578 for the year 1981, be and the same is hereby modified in accordance with the foregoing opinion. In all other respects, the action of the Franchise Tax Board is 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. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9