BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FRED DALE STEGMAN)

For Appellant: James H. Cesena
Attorney at Law

For Respondent: Karl F. Munz
Counsel

OPINION

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 Fred Dale Stegman for redetermination of a jeopardy assessment of personal income tax in the amount of $25,650 for the period January 1, 1982, to May 21, 1982.

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

The following summary of facts, except where otherwise indicated, is taken from arrest reports of the Riverside County Sheriff's narcotics investigators. On May 21, 1982, police officers were called to investigate a possible illegal narcotics laboratory. After a search of the premises, the officers concluded that a narcotics laboratory was being operated and arrested appellant and two other persons. Evidence seized at the scene included various chemicals, laboratory equipment, and eighteen kilograms of pure cocaine. While being detained in a sheriff's car, appellant hid an eight-gram bag of cocaine and two bottles of cutting agent under the passenger seat. Following his arrest, appellant was indicted, and at the time briefs were filed in this appeal the criminal action against him was pending.

After being informed of appellant's arrest, respondent terminated appellant's 1982 taxable year and issued a jeopardy assessment in the amount of $25,650. In issuing the jeopardy assessment, respondent found it necessary to estimate appellant's income for the appeal period. The estimate was based upon the value of the cocaine seized at the time of appellant's arrest. The total value of the cocaine was computed by multiplying eighteen, the number of kilograms seized, by $63,000, the wholesale value of each kilogram. Respondent determined that appellant had three partners, two who were arrested with appellant and one arrested later. On the basis of these facts, respondent determined that appellant had a one-fourth interest in the cocaine and that his share was worth $283,500. Respondent concluded that appellant had unreported taxable income in that amount, resulting in the $25,650 assessment. Respondent denied appellant's petition for redetermination of the jeopardy assessment, and this appeal resulted.

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.) Gross income includes gains derived from illegal activities, including the illegal sale of narcotics, which must be reported on the taxpayer's return. (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), 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 (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 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 use of the net worth method and the cash expenditure method has been approved by the 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 of 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 p. 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, 86 (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 p. 565.) If such proof is lacking, the government's determinations are arbitrary and cannot be sustained. (Thomas v. Commissioner, supra; Taglianetti v. United States, supra.)

In the appeal before us, respondent's reconstruction of appellant's income is based upon its determination that appellant purchased one-fourth of the cocaine found in his possession for $283,500, and that the money needed for this purchase was earned between January 1, 1982, and May 21, 1982. However, the record in this appeal contains absolutely no evidence of appellant's financial situation including his net worth as of the beginning of that period. Therefore, respondent's conclusion that the money was earned after January 1, 1982, is pure conjecture, and its reconstruction of income is arbitrary and cannot be sustained.

For the above reasons, respondent's action must be reversed.

Appeal of Fred Dale Stegman

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 Fred Dale Stegman for redetermination of a jeopardy assessment of personal income tax in the amount of $25,650 for the period January 1, 1982, to May 21, 1982, be and the same is hereby reversed.

Done at Sacramento, California, this 8th day of January , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9