'-'-BEFORE THE STATE **BOARD OF EQUALIZATION**

OF THE **STATE OF** CALIFORNIA

In the Matter of the Appeal of)
) No. 82J-1638-KP
DEAN R. HENDERSON)

Appearances:

For Appellant: Dean R. Henderson, in pro per.

For Respondent: B. (Bill) S. **Heir Counsel**

OP IN 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 petitions of Dean R. Henderson for reassessment of a jeopardy assessment of personal income tax and penalties in the total amount of $59,605.00 for the year 1974, and for reassessment of jeopardy assessments of personal income tax in the amounts of $6,776.00 and $17,614.76 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 years in issue.

Appeal of Dean R. Henderson

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

In 1969, appellant formed an investment brokerage business through which he allegedly paid investors better-than-market interest rates, Over the next five years, appellant allegedly received somewhere between $250,000 and $500,003 from approximately 62 investors. In 1974, appellant's operation was closed by both state and federal agencies and he was charged with fraud, violations of securities laws, and forgery by both the State of California and the federal government. In 1975, appellant pled nolo contendere tothestate charges and • fjas placed on probation. In 1976, appellant pled guilty to federal fraud charges and was sentenced to five years in federal prison.

On or about February 1, 1981, appellant arranged to buy a mobile home from an elderly woman for $49,000. He paid $4,000 cash and gave her a note for the balance of the purchase price which was due on August 15, 1981. Appellant did not repay the note nor did he pay any interest. Appellant resold the trailer to a second woman for $48,000. When the second woman was unable to obtain financing from a bank, appellant arranged for a third woman to lend $35,000to the second woman who in turn paid that amount over to appellant. Appellant then arranged for the balance of the purchase price, plus $2,000, to be "paid" to appellant by a business solely owned and operated by appellant, a fact unknown to- the buyer of the mobile home, The buyer was then required to make payments, consisting of principal and interest, on that second loan to that corporation.

During the same year, appellant solic ited "loans" or "investments" from other individuals for various businesses under his sole control and ownership. None of the known "loans" or "investments" were repaid and none of the investors received any interest or dividends. Eventually, appellant was arrested and charged with grand theft and securities. fraud violations in connection with those events. Pursuant to an apparent plea bargain, the grand theft charges were dropped and appellant was found guilty of the securities code violations. He was sentenced to one year in jail and three years probation.

After his arrest in 1981, a search of. appellant's hone revealed cash and various records of

appellant's activities. Afterrespondent was informed of the above events and discoveries, it determined that appellant had unreported income for the years at issue and that the collection of the tax on that income would be jeopardized by delay. Respondent determined, based on federal information filed in connection with the 1975 federal charges, that appellant had $425,000 of unreported income for 1974. Further, respondent determined, through the expenditure method of income reconstruction, that appellant had $223,416 in unreported income for 1981. Jeopardy assessments and an order to withhold all of the cash found during the search of appellant's residence were issued. The cash was applied against appellant's tax liabilities,

Subsequently, appellant filed petitions for reassessment. Upon reviewing appellant's records for 1981, respondent discovered various problems with its cash expenditures reconstruction of income. Eventually, respondent agreed that the records appellant provided at his reassessment hearing were a more accurate reflection of his gross income for that year. Respondent refused, however, to allow any deductions for the operation. of appellant's "business" as it determined that he was engaged in illegal activities. Accordingly, respondent reduced its 1981 assessments to $4,329.76, but upheld its 1974 assessment in its entirety. 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 illegal activities constitutes gross income. (See, e.g., Farina v. McMahon, 2 A.F.T.R.2d (P-H) ¶ 58-5246 (1958).)

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. 3 446.) 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 of proving that a reasonable recoil-struction 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, ¶ 54,275 T.C.M. (P-H)(1964),affd.sub nom., Fiorella v. Commissioner, 361 F.2d 324 (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, 476 F.2d 101 (7th Cir, 19691; Whitten v. Commissioner, ¶ 80,245 T.C.M. (P-H) (1980); Appeal of David Leon Rose, Cal. St. Bd. of Equal., Mar. 8, 1976.)

We begin by examining respondent's determination that appellant received $425,000 unreported income in 1974. Respondent's argument tests upon the contents of federal criminal information filed against appellant in 1975. Respondent has failed, however, to include a copy of that information. Even if respondent had produced a copy of that report, we doubt, for the reasons stated below, that its contents would support respondent's 1974 income reconstruction.

Respondent has included as evidence a copy of the probation report. filed in the 1975 state action against appellant. *The report* indicates that appellant was charged with defrauding investors of an estimated $250,000, not $425,000 as alleged in the federal information. It is also evident that the charges encompass all of the years that appellant was in operation, 1969 through 7974. There is no breakdown in any of the evidence on appeal as to how much. money appellant made during each of the years of operation. The $250,000 figure used by the court was simply a *lump-sum* estiaate of the total amount of money appellant took from his " investors" during the five years he was in business. Due to the nature of criminal investigations, it is logical to assume the federal. informationwas based on the same five-year period and that the $425,000 figure was a federal, estimation of the total amount appellant embezzled from his "investors."

Furthermore, none of the known victims of appellant's fraud were defraudad in 1974. It appears from his victims' testimonials attached to the probation report that the majority, if not all, of appellant's "cons" occurred prior to that *year.* Simply put, *nothing*

in the record documents a single taxable event that occurred in 1974. Consequently, we find that there is no support in the record for respondent's reconstruction of appellant's income for 1974. Therefore, respondent's action is based on assumptions Lacking corroboration in the record, and its assessment is arbitrary and unreasonable. (Shades Ridge Holding Co., Inc. v. Commissioner, supra.)

> [W]here 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 Cit. 1947).)

We next turn to respondent's assessment for 1981. We note that respondent's revised gross income estimation is based upon records produced by appellant during appellant's petition for rehearing, AR income reconstruction that is based upon a taxpayer's own records is valid. (See Appeal of Rosa Gallardo, Cal. St, Bd. of Equal., July 29, 1986; Appeal of Bruce James Wilkins, Cal. St. Bd. of Equal., May 4, 1983.) Consequently, we find that respondent's estimation of appellant's unreported gross income for 1981 is supported by the record and that appellant has failed to produce evidence to contradict this finding.

En his multifaceted attack on respondent's 1981 assessment, however, appellant does touch upon one aspect of respondent's determination that bears closer scrutiny. Appellant takes issue with the fact that respondent did not allow any deductions against gross income.. Appellant argues that he was not engaged in anp illegal activities, as evidenced by the fact that the grand theft charges were dropped, and that he is entitled to his legitimate business deductions.

Respondent based its decision to disallow any deductions upon section 1'7297.5. Section 17297.5 states, in relevant part, that:

> (a) In computing taxable income, no deductions ... shall be allowed to any taxpayer on any of his or her gross income

> directly derived from illegal activities as defined in ... Chapter 4 (commencing with Section 484 [theft]) ...of Title 13 of, Part I of the Penal Code ... 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, those illegal activities"
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> * * *
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> (c) This section shall [apply] to taxable years which have not been closed by a statute of limitations, res judicata, or other-wise.

As appellant was charged with violations of section 487 of the Penal Code, grand theft, section 17297.5 applies to this appeal. Furthermore, appellant's contention that respondent's assessment is erroneous because the grand theft charges did not result in a conviction has been thoroughly discussed in prior cases and rejected. (See, e.g., Appeal of Alan E. French, Cal. St. Bd, of Equal., Mar. 4, 1986; Appeal of Bee Yang Juhang, Cal. St. Bd. of Equal., Nov.6,1985.) A conviction is not necessary to support the conclusion that a prima facie case has been established that a taxpayer has received unreported income from illegal activities. (Appeal of Carl E. Adams, Cal. St. Bd. of Equal., Mar. 1, 1983.) 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, supra.)

The evidence presented in this appeal indicates that appellant engaged in a pattern of criminal activity in 1981 and that he received income from that activity. Appellant apparently *purchased" a mobile home with no intention of paying for it. No attempt was made to comply with the terms of the note. All inquiries by the seller as to payment on the note were rebuffed. Appellant's intent to defraud is further made evident 'by the fact that he resold the trailer at a "loss" and, rather than paying off the first note, pocketed a majority of the sales price and arranged a second note for the balance of the purchase price in his favor. Furthermore, appellant apparently obtained cash from other individuals

with no intention of returning the cash or paying the promised interest. Again, any inquiries by the lenders resulted in promises but no payments. Consequently, we find that respondent has established a prima facie case that appellant was involved in illegal attempts to defraud individuals and that he made income from those efforts. As we have come to this conclusion, we find that respondent was correct in disallowing any deductions from gross income under section 17297.5 as that income was derived from illegal activities described in that section.

In summary, we find that respondent's assessment for 1974 is arbitrary, as there is no evidence in the record to support its estimation of appellant's income for that year. That assessment must be reversed. In contrast, we find that respondent's revised reconstruction of appellant's 1981 income is supported by the record on appeal and that, as appellant has failed to produce evidence to the contrary, it must be sustained.

Appeal of Dean R. Henderson

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 petitions of Dean R. Henderson for reassessment of a jeopardy assessment of personal income tax and penalties in the total amount of $59,605.00 for the year 1974, and for reassessment of jeopardy assessments of personal income tax in the amounts of $6,776.00 and $17,614.76 for the year 1981, be and the same is hereby reversed with respect to the assessment for 1974. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 19th day Of November , 1386, 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

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In the Platter of the Appeal of)	
)	No. 82J-1638-KP
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ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed December 19, 1986, by Dean R. Henderson for rehearing of his 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 denied and that our order of November 19, 1986, be and the same is hereby affirnef.

Done at Sacramento, California, this 3rd day of February, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburq, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9