BEFORE THE STATE BOARD OF EQUALIZATION

'OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) NO. 85R-578-VN
)
THOMAS DEMOGENES)

Appearances:

For Appellant: Robert J. Lowe
Attorney at Law

For Respondent: 'Lorrie K. Inagaki
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 claim of Thomas Demogenes for refund of'personal income tax in the amounts of $792 and $17,474 for the year 1982 and for the period January 1, 1983 to May 6, 1983, respectively.

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

The issue presented for our decision is whether the Franchise Tax Board properly reconstructed appellant's income from an illicit out-call massage and escort business.

In February 1982, the Los Angeles Police Department began an undercover investigation into the operations of a telephone out-call massage and escort service business called "Eve's" whose female escorts were suspected to be engaged in prostitution. In November 1982, appellant purchased the going 'concern for $18,500 and continued operating the out-call service as a sole proprietorship..

During the next few months of its investigation, the police discovered that appellant had about 20 women working for him, several of whom were arrested for solicitation for prostitution.. As a matter of business practice, customers would call appellant's out-call service to obtain escorts who were then dispatched to the customer's location. On arrival, the escorts were required to collect a $55 fee that appellant's business charged for its out-call services. The escorts negotiated their own compensation beyond this $55 service fee. Customers were able to pay the service fee and escort's compensation either in cash or by making a credit card purchase on approval of the out-call service. For cash transactions, the escorts apparently remitted only the $55 service fee to appellant's business. For credit card transactions, however, the escorts turned in the credit card vouchers to appellant who paid the escorts their compensation within a week. The police learned that appellant then sent' the vouchers to two sham corporations in Texas whose owner processed the vouchers through the credit card companies for an agreed percentage of the credit card receipts. Appellant subsequently received payment of the credit card purchases less the "laundering" charge. Appellant would deposit the funds into the bank accounts of two real @state companies that he also owned. When confronted by the police, the owner of the credit card laundering operation voluntarily relinquished detailed ledgers and records of his credit card collections and payments.

On May 7, 1983, appellant, was arrested and charged with nine felony counts of pimping and pandering and conspiracy to commit pimping and pandering. He later pleaded guilty to one count of conspiracy to commit pandering and was sentenced to one year of formal probation with the additional conditions.that he pay a $2,500 fine and perform 500 hours of community service.

On May 12, 1983, the Franchise Tax Board issued jeopardy assessments based on the information provided by

police. Respondent determined that appellant had received unreported income from pimping and pandering during the last two months of 1982 and the period from January 1, 1983 to May 6, 1983. Following a hearing on a petition for reassessment, respondent eventually revised its initial assessments. to reflect its determination that appellant's income from his illicit out-call business was $34,390 in 1982 and $169,828 in 1983. Appellant thereupon appealed to this board for relief but paid the assessments. Consequently, this matter shall be treated as an appeal from a denial of a claim for refund.21

In these proceedings, appellant does 'not deny that he was engaged in pimping and pandering or that he received income from such illegal activity during the two periods in question. Rather, appellant objects to the Franchise Tax Board's reconstruction of that income. Using business records seized by the police and information provided by appellant, respondent reconstructed appellant's income from both cash sales and credit card transactions. With regard to appellant's income from cash sales, respondent simply accepted appellant's own estimate of his cash income which was based on the claimed number of cash transactions multiplied by the $55 service fee. As for appellant's income from credit card transactions, respondent first determined from the records kept by the laundering operation the amount of money from the credit card companies that was ultimately paid to appellant. Respondent then concluded that the total amount of those payments ($22,405 in 1982 and $167,908 in 1983) should be included in appellant's pimping and pandering income based on his receipt of the funds.

Appellant contends that it is erroneous to ascribe all of the credit card payments that he received to his income when he was charged only with the $55 fee for each cash sale and the credit card vouchers included additional compensation earned by and payable to the escorts. It is appellant's position that his credit card income should be limited, as it was for the cash sales, to the $55 fee that his business charged.each customer for the purchase of escort services (less a processing fee allegedly deducted from the proceeds by the credit card companies). Appellant asserts that, based on the number of credit card transactions shown in the record, his pimping and pandering income from credit

2/ After this appeal was filed, respondent determined that appellant's income from pimping and pandering should have been estimated at $38,072 for.1982 and $182,220.30 for 1983. However, respondent chose not to revise its assessments again to reflect this additional income.

card sales should be reduced to $14,520 in 1982 and $42,916 in 1983. The balance of the **credit card** payments, appellant argues, represented income earned by the escorts and should be excluded from his income. He contends that he did not receive those allegedly excess amounts under a claim of right, but merely as a conduit who'was required to transfer the funds to the escorts upon receipt and that he did in fact transmit these sums to the escorts.

It is well settled that both federal and state income tax regulations require each taxpayer to maintain such accounting records as will enable him to file an accurate tax return. (Treas. Reg. S **1.446-1(a)(4).)** In the absence of reliable books or records, **the** taxing agency is given great latitude to determine a taxpayer's taxable income by whatever method will, in its opinion, clearly reflect income. **(Rev. &** Tax. code, S 17561, **subd. (b); Giddio** v. Commissioner,.54 T.C. 1530 **(1970).)** The choice as to the method of reconstructing income lies with the taxing agency; the only restriction being that the method be reasonable under the circumstances. (Carson v. United States, 560 **F.2d** 693 (5th Cir. 1977); Schellenbarq **v. Commissioner,** 31 **T.C.** 1269 **(1959).)** Moreover, where a' **taxpayer** has failed to maintain any books or records of his transactions, respondent's method need not compute net **income with** mathematical exactness in order to be reasonable. (Gordon **v.** Commissioner; 63 T.C. 51 **(1974);** Harbin v. Commissioner, 40 T.C. 373 **(1963).)** "Under such circumstances, approximation.in the Calculation of net income is justified." (Harris v. Commissioner, **174 F.2d** 70, 73 (4th **Cir. 1949).)** Thus, so long as some reasonable basis has been used to reconstruct income, respondent's determination will be presumed correct, and the taxpayer bears the burden to disprove such computation even though crude. (Breland v. United States, 323 **F.2d** 492 (5th Cir. **1963).)**

Gross income is defined as all income from whatever source derived and includes compensation for services and gross income derived from business. (Rev. **& Tax.** Code, S 17071, subd. (a).) The general principle is that a taxpayer must include in his gross income funds which he receives under a claim of right and without restrictions as to its disposition. (North American Oil Consolidated v. Burnet, 286 U.S. 417 **[76 L.Ed.** 11971 **(1932); Appeal of Anthony** C. and **Cecelia** I. **Rossi,** Cal. St. Bd. of Equal., Jan. 6, 1981.) Funds are received under a claim of **riqht** when treated by a taxpayer as if they belong to him. (Healy v. Commissioner, 345 U.S. 278 **[97 L.Ed.** 10071 **(1953).)** That the amounts received under a claim of right are **in** the nature of **unlawful** gains does not alter the fact that they **constitute income** to the recipient. **(Lydon v.** commissioner, 351 **F.2d** 539 (7th Cir. **1965).)** Unlawful gains constitute

taxable income so long as the recipient has such control over the funds that he derives an economic benefit. (Rutkin v. United States, 343 U.S. 130, 137 [96 L.Ed. 8331 (1952).)

On the other hand, "a taxpayer need not treat as income moneys which he did not receive under a claim of right, which were not his to keep, and which he was required to transmit to someone else as a mere conduit." (Diamond v. Commissioner, 56 T.C. 530, 541 (1971), affd. 492 F.2d 286 (7th Cir. 1974).) The taxpayer's prompt payment of the amounts received is indicative not only that he was a mere conduit but also that he had no claim or right to the funds. (Goodwin v. Commissioner, 73 T.C. 215, 230 (1979): Ludwig v. Commissioner, ¶ 83,678 T.C.M. (P-H) (1983).) In the absence of gain or profit, the mere receipt or possession of cash is therefore not sufficient to occasion taxation if-the amounts received are promptly transmitted to another. (Lashell's Estate v. Commissioner, 208 F.2d 430, 435 (6th Cir. 1953).) Thus, where a taxpayer acts as a mere conduit for funds, the existence of the claim of right is negated and the amounts received are not income to him. (Goodwin v. Commissioner, supra.)

On the basis of the record in this appeal, we must find that appellant has failed to prove that he received the credit card payments as a mere conduit. Appellant has contended that a great portion of these receipts were payable to the escorts as their compensation, but there is no evidence that appellant actually transferred any portion of the credit card payments that he received directly to the escorts. Appellant himself has admitted that payments from the credit card companies were not received for several weeks or months after the submission of the charge vouchers to the laundering operation. It was his practice, appellant has stated, to advance the escorts their compensation within a few days of each credit card transaction and later retain the full amount of the credit card proceeds for himself when he received them. In other words, appellant did not simply act as a collector of the credit card funds who immediately transmitted a share to the escorts. On the contrary, appellant received the credit card proceeds under a claim of right and controlled the use of the funds for his own economic benefit. Here the evidence shows that on receipt of the payments from the Texas laundering operation appellant deposited the moneys into the bank accounts of his other businesses. He thus treated the money as his own. We must therefore conclude that the full amount of the credit card payments received by appellant were properly included in his gross income for the appeal periods.

Having found that appellant was taxable on all of the credit card receipts, a subsidiary issue is whether he is allowed any deductions from his income from'pimping and pandering for either the advances that he made to the escorts or the processing fees that he allegedly paid to. the credit card companies. In computing taxable income, section 1728.2, subdivision (a), prohibits any deduction from gross income directly derived from illegal activities, which includes the crime of pandering under section 2663 of the Penal Code.21 Inasmuch as appellant was convicted of conspiracy to commit pandering, we are bound by that determination to find that appellant is not entitled to any deductions from'the gross income derived from that illegal activity. (Rev. & Tax. code, S 17282, subd. (b).)

In summary, we find that appellant has not carried his burden of proving that respondent's reconstruction of his income from pimping and pandering was unreasonable in any part. Respondent's assessments of tax and denial of appellant's refund claim must be therefore sustained. In penalties assessed for the 1982 period for appellant's failure to file a timely return and negligence must be upheld since appellant has not made any argument against their imposition.

3/ While section 17282 was amended in 1984 to add the references to sections 266h and 2661 of the Penal Code (Stats. 1984, Ch. 962, S 1, pp. 3335-3336), subdivision (c) nevertheless provides that section 17282 is to be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise. Section 18586, subdivision (a), provides that the statute of limitations for issuance of a deficiency assessment for that particular year is four years from the due date of the return for that year. (Appeal of Peter I. and Inqa M. Rune, Cal. St. Bd. of Equal., June 27, 1984.)

Appeal of Thomas Demogenes

ORDER

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 Thomas Demogenes for refund of personal income tax in the amounts of $792 and $17,474 for the year 1982 and for the period January 1, 1983 to May 6, 1983, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of April, 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, and Mr. Davies present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

John Davies*, Member

_______________, Member

_______________, Member

*For Gray Davis; per Government Code section 7.9