

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
MONROE BRANTLEY)

Appearances:

For Appellant: Monroe Brantley,,
in pro. per.

For Respondent: Jon Jensen
Counsel

OP I N I O N

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 Monroe Brantley for reassessment of a jeopardy assessment of personal income tax in the amount of \$8,498.28 for the period January 1, 1980, through December 1, 1980.

Appeal of Monroe Brantley

The question presented by this appeal is whether respondent properly reconstructed appellant's income during the appeal period. In order to properly consider this issue in light of the applicable law, we are compelled to provide the following factual summary taken from various police reports, tax notices, tax returns, and the transcript of the reassessment hearing.

In October 1979, the Inglewood Police Department began to suspect that appellant was conducting an after-hours night club business from within his residence after a confidential informant disclosed that appellant was selling cocaine and liquor at his house on Friday and Saturday evenings. Subsequently, a neighborhood block club complained of traffic and parking problems caused by the apparent operation of an after-hours club at appellant's address. When police investigators confronted appellant and advised him of the complaints, appellant stated he would soon find a commercial building for hosting of his "parties."

One year later, a veteran Los Angeles police officer assigned to the narcotics detail was furnished additional information that appellant was trafficking substantial amounts of cocaine and marijuana from his Inglewood home. Two confidential informants advised the officer that, for the past six months to a year, they had purchased cocaine from appellant at his residence which he converted into an after-hours club four nights each week. They described the residence as a single-family home with its doors and windows protected by metal bars which, police statements add, is characteristic of narcotic sellers. The tipsters stated appellant charged an admission fee and sold cocaine, marijuana, and alcoholic beverages to 200 or 300 customers who frequented the night spot each evening.

Based upon this information indicating there was probable cause that a felony was being committed at the residence, the Los Angeles Police Department obtained a warrant to conduct a night-time search for narcotics and related paraphernalia. On December 1, 1980, police officers executed the search warrant and uncovered a kilogram of marijuana, various drug paraphernalia, lactose cutting agent, two firearms, and \$6,673 of cash in appellant's house. In addition, the officers found signs referring to an after-hours night club, including one which, stated that Thursday and Sunday nights were "ladies' nights." No cocaine was seized, but a minute quantity of white powder was observed on the floor of the

Appeal of Monroe Brantley

bathroom from which appellant was seen leaving before his detention. Appellant was then arrested and apparently later charged with possession of marijuana for sale in violation of section 11359 of the California Health and Safety Code, a felony.

Shortly thereafter, respondent was notified of the arrest and estimated from information provided by Inglewood police authorities that appellant had received \$526,400 in taxable income from the sale of cocaine at his home for the eleven-month appeal period. Under the circumstances, respondent determined that collection of the resultant tax liability would be jeopardized by delay and issued a jeopardy assessment, thereby terminating appellant's taxable year as of the date of his arrest.

Subsequently, appellant filed a petition for reassessment of the jeopardy assessment as well as California personal income tax returns for the years 1978, 1979, and 1980. On the returns for 1979 and 19'80, appellant reported income from the sole proprietorship business involving the "rental" of his home for "parties." From gross receipts, appellant deducted the cost of goods sold for "refreshments" and expenses for "bartenders" and "food service." On the returns for 1978, 1979, and 1980, appellant disclosed additional income from a hairstyling business. No income was reported from liquor or drug sales for any of the three years. Thereafter, appellant submitted for respondent's review a completed financial questionnaire in which he likewise reported no income from the sale of drugs. Appellant also claimed to have filed returns for the years 1975 and 1976, but respondent avers that its records do not show that those returns were ever filed.

At the hearings on the petition for reassessment, respondent was unable to procure substantive evidence of appellant's alleged drug activities but made inquiry into the nature of the two businesses indicated in his returns. With regard to the home rental or party business, a police officer present at appellant's arrest testified that appellant told him he rented his house for parties and supplied **alcoholic beverages**. Appellant testified that he held parties and receptions at his house every week and served food at these gatherings. For a party of 25 persons, he stated he would earn \$150 per evening with earnings estimated to be **\$200-\$300** per weekend. Appellant admitted that he did not maintain a set of books and records for his home party business and the income and expense figures supplied to his tax

Appeal of Monroe Brantley

preparer were "strictly estimates." As for the hair-styling business, appellant testified he had anywhere from two to six beauticians working in his salon at any time. He conducted business on a cash-only basis. Payments for services rendered and commissions paid to operators were made in cash. Appellant did not keep a separate checking account for the business nor did he ever hire an accountant to reconcile any books or records. Appellant brought bills, receipts, letters, calendars, and appointment books to the hearing but yet could not produce any receipts for expenses incurred in connection with the beauty salon. Respondent was unable to verify or reconcile the income figures indicated on appellant's returns with the bills and receipts.

Upon review of the available evidence and testimony from the reassessment hearing, respondent determined it lacked sufficient proof of appellant's cocaine sales activities to warrant the reconstruction of income from such illegal sources. On the other hand, respondent revised its initial jeopardy assessment to reflect a reconstruction of appellant's income from his home rental business and hairstyling salon. Under the revised reconstruction formula, respondent has determined that appellant realized a net profit of \$66,270 from the home rental business and \$26,000 from the hairstyling business for the appeal period. Respondent thus calculated appellant's income to be \$92,270 **before** allowance of itemized deductions claimed on his 1980 return. The tax liability at issue in this appeal arises from this determination.

Appellant has appealed this revised assessment, contending that the income figures are without foundation. Thus, the sole issue is whether respondent properly reconstructed the income **that appellant** derived from the rental use of his residence for "parties" or as an "after-hours club" and from his ownership of the hair-styling salon.

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. **§ 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 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,

Appeal of Monroe Brantley

§ 17561, subd. (b); Joseph F. Giddio, 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); Herbert Schellanberg, 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. (Harry Gordon, 63 T.C. 51 (1974); Harold E. Harbin, 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).)

In general, the existence of unreported income may be demonstrated by any practical method of proof that is available in the circumstances of a particular case. (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of Karen Tomka, Cal. St. Bd. of Equal., May 19, 1981.) In the instant matter, respondent employed the now familiar projection method to reconstruct appellant's income from his operation of the after-hours club in his home and beauty salon. The projection method based upon statistical analysis and assumptions gleaned from the evidence is an acceptable method of reconstruction. (Mitchell v. Commissioner, 416 F.2d 101 (7th Cir. 1969); Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.) However, in order to ensure that use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income that he did not receive, each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Willits v. Richardson, 497 F.2d 240 (5th Cir. 1974); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976) In other words, there must be credible evidence in the record which, if accepted as true, would induce a reasonable belief that the amount of tax assessed against the taxpayer is due and owing. (United States v. Bonaguro, 294 F.Supp. 750 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono,

Appeal of Monroe Brantley

428 F.2d 204 (2d Cir. 1970); Appeal of Burr McFarland Lyons, supra.) If the reconstruction is round to be based on assumptions lacking corroboration in the record, the assessment is deemed arbitrary and unreasonable. (Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. subnom., Fiorella v. Commissioner, supra.) In such instance, the reviewing authority may redetermine the taxpayer's income on the facts adduced from the record.- (Mitchell v. Commissioner, supra; F.O. Whitten, Jr., ¶ 80,245 P-H Memo T.C. (1980); Appeal of David Leon Rose, supra.)

First, because of the absence of records to substantiate the gross receipts and deductions taken for his home rental business, respondent found it necessary to resort to three assumptions to reconstruct appellant's taxable income therefrom.. First, respondent determined that appellant operated an "after-hours club" from his residence and sold alcoholic beverages, food,, and narcotics to customers. Second, respondent concluded that appellant was engaged in this business for the **eleven-**month period in 1980 between January 1 and December 1. Notwithstanding appellant's denial of drug dealing and respondent's decision not to impute any drug income to him, we find these two assumptions to be **entirely reason-**able in light of appellant's admissions and the documentation provided by law enforcement agencies.

The third assumption made by respondent involves a formula calculation of appellant's taxable income from his after-hours club. Respondent assumed that for each rental party of 25 customers, appellant earned \$150 in cover charges or house rental fees; once inside, each customer paid \$10 for food or catering fees and purchased \$8 worth of alcoholic beverages. Respondent allowed, a 55% deduction from gross receipts for cost of goods sold in accordance with standard business practices. Finally, respondent determined that appellant operated the after-hours club for 188 days or four days per week during the appeal period. Our review of the evidence reveals that there is sufficient credible evidence to support this computation of appellant's taxable income. The \$150 figure for house rental fees was supplied by appellant at the reassessment hearing. Since we have found that appellant served food and alcoholic beverages at his club, the per-customer food and liquor charges are reasonable notwithstanding appellant's denials and contradictory statements about income from such sales. In regard to the frequency of business activity, the record shows that, three months prior to

Appeal of Monroe Brantley

the appeal period, a tipster and the neighborhood organization related information to the police about an **after-hours** spot operating on Friday and Saturday nights. The two informants, who provided the information of appellant's cocaine sales activity that formed the basis for the search warrant, stated appellant did business four times per week. When searching appellant's house, the arresting officers observed a business sign **referring** to "ladies' nights" on Thursday and Sunday evenings. At the reassessment hearing, appellant testified earning between \$200 and \$300 just on weekends from rental fees. Thus, in our view there is an ample factual foundation to support the assumption that appellant operated this business four nights during **each** week of the appeal period. Respondent's determination of appellant's taxable income from his after-hours **club** will be sustained.

Second, the reconstruction of appellant's income from the hairstyling salon proceeded on the assumption that the business contracted for **the** services of five full-time cosmetologists. By speaking with several beauty salon owners, respondent's hearing officer determined that a full-time **beautician** earned a minimum of \$500 in gross receipts per week. Deductions from gross receipts were allowed in the amount of 60 percent for commissions paid to the cosmetologists and 20 percent for the cost of goods sold.

In view of appellant's failure to keep any records for his beauty salon business or offer any evidence by which his taxable income may be ascertained or his return substantiated, we find that respondent's method of income reconstruction to be justified and reasonable under the circumstances. Since it behooves appellant to produce facts and figures in his control which would result in a more precise calculation of his income, his failure of proof requires us to uphold the assessment. (See Breland v. United States, supra; Appeal of Paul Joseph **KeIner**, Cal. St. Bd. of Equal., Sept. 30, 1980.) Respondent's computation should be reduced by \$2,000 to reflect income over the 48 weeks between January 1, 1980, and December 1, 1980. This oversight, however, is not fatal to the presumption o'f correctness attached to the determination.

For the above **reasons**, we conclude that appellant realized a net profit of \$90,270 from his two business enterprises during the period in issue. Accordingly, respondent's jeopardy assessment will be sustained as modified herein.

Appeal of Monroe Brantley

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 Monroe Brantley for reassessment of a jeopardy assessment of personal income tax in the amount of **\$8,498.28** for the period January 1, 1980, through December 1, 1980, be and the same is hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this **13th** day of December, **1984**, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9