



87-SBE-010

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JOHN R. AND LOUISE R. WOLFE) No. **84A-617-KP**

For Appellant: John R. Wolfe,
in pro. per.

For Respondent: Paul J. Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section **18593^{1/}** of the Revenue and Taxation-Code from the action of the Franchise Tax Board on the protest of John R. and Louise R. Wolfe against proposed assessments of additional personal income tax in the amounts of **\$1,593.56, \$6,994.10, and \$7,090.84** for the years 1971, 1972, and 1973, respectively.

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 John R. and Louise R. Wolfe

The issues presented by this appeal are whether respondent has properly included in Mr. Wolfe's income for 1973, the amount of a civil fine owed by Mr. Wolfe but paid by his employer and, if so, whether appellant may deduct the amount of the fine on his 1973 tax return. As Mrs. Wolfe is a party to this appeal solely because she filed joint tax returns with her husband for the appeal years, Mr. Wolfe will be referred to as "appellant."

During the years at issue, appellant was employed by **Bestline** Products, Inc., a corporation engaged in the production of household cleaning products and their door-to-door sale. In the sale of its products, **Bestline** enlisted members of the general public to sell the products while encouraging the sales people to solicit others to sell on the same basis.

On January 14, 1971, a California court entered a final judgment against **Bestline** and its employees, including appellant, declaring the **Bestline** marketing methods illegal under California Business and Professions Code section 17500. The judgment also enjoined **Bestline** and its employees from the continued marketing of **Bestline** products in that illegal manner. Sometime thereafter, the California Attorney General determined that **Bestline** and its employees had continued their operation in violation of the court decree. Appellant and the others were again charged in a civil proceeding with violating Business and Professions Code section 17500. **Bestline**, appellant, and the other employees were found guilty and given civil fines. **Bestline** paid appellant's \$50,000 fine.

Subsequently, respondent audited appellant's tax return for the years at issue. Respondent included as appellant's income the \$50,000 fine paid on appellant's behalf by **Bestline**. Respondent also disallowed deductions for various expenses appellant incurred on behalf of his **Bestline** activities under the belief that those expenses were associated with illegal activities and were not deductible under section 17297.5^{2/} Appellant protested the denial of the deductions, stating that his violation of the Business and Professions Code

2/ Former section 17297.5, in pertinent part, stated that "(a) [i]n computing taxable income, no deductions (including deductions for cost of goods sold) shall be allowed to any taxpayer on any of his or her gross income

Appeal of John R. and Louise R. Wolfe

was civil, not criminal, in nature. Appellant also contended that the payment of the fine to the state was of no advantage to him and should, therefore, not be included in income. Furthermore, appellant argued that the payment of fines by employers for fines levied against employees as a result of actions undertaken during the course of their employment should be encouraged as a matter of public policy. Finally, appellant argued that if the payment of the fine is included in income, then the payment of the fine to the state should be a deduction as an ordinary and necessary business expense.

Respondent rejected these contentions, arguing that the conviction was criminal in character. This appeal followed. During the course of this appeal, the appeal filed with regard to the underlying court action which imposed the fines in question was decided. In People v. Bestline Products, Inc., 61 Cal.App.3d 879 (132 Cal.Rptr. 7671 (1976), the court of appeals upheld the imposition of the fines but stressed that the fines were civil in nature, not criminal: As a result, respondent has changed its position and allowed the deduction of all of the claimed business expenses except the payment of the fine, thereby reducing its assessments for 1971 and 1972 to zero and for 1973 to **\$4,399.77**. Accordingly, the only issues remaining for our consideration are those regarding the propriety of including the fine amount as income and denying the deduction of that amount.

The remaining issues on appeal have been addressed and resolved by the United States Tax Court in Buff v. Commissioner, 80 T.C. 804 (1983), in which appellant was a named petitioner. We note that the disposition of appellant's case on the federal level is highly persuasive as to the result which should be reached in this appeal. (Appeals of O.S.C. Corporation, et al., Cal. St. Bd. of Equal., Dec. 3, 1985; Appeal of William C. and Kathleen J. White, Cal. St. Bd. of Equal., June 23, 1981.)

2/ Continued

directly derived from illegal activities" Section 17297.5 was specifically made **retroactive** to all taxable years which were not closed by the statute of limitations or otherwise. (Former Rev. & Tax. Code, § 17297.5, subd. (c), reenacted as section 17282 (Stats 1983, ch. 488).)

Appeal of John R. and Louise R. Wolfe

The court in Huff ruled that the payment of the fine did result in income to appellant as it extinguished a financial obligation owed by appellant. Therefore, appellant realized economic benefit in the payment. Furthermore, the court decided that California's public policy *encouraging indemnification of employees by employers for acts committed in the course of their employment was not violated by the inclusion of the fine amount as gross income. Finally, the court ruled that the payment of the fine to the state could not be deducted because Internal Revenue Code section 162(f)(3), specifically bars the deduction of civil **penalties** imposed upon a taxpayer.

Since the statutes and policies of California's tax laws involved in this appeal are based upon the federal statutes and policies described above, we find that the reasoning of the tax court is extremely **persuasive**. We, therefore, adopt the findings and holdings of the tax court in this matter. Consequently, respondent's action in this matter with regard to the civil fines must be sustained.

3/ The California equivalent of I.R.C. section 162(f) **was** section 17202, subdivision (d).

Appeal of John R. and Louise R. Wolfe

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 on the protest of John R. and Louise R. Wolfe against proposed assessments of additional personal income tax in the amounts of **\$1,593.56, \$6,994.10, and \$7,090.84** for the years 1971, 1972 and 1973, be and the same is hereby modified in accordance with the concessions of the Franchise Tax Board. In all other respects, the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 6th day of January, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

<u>Conway H. Collis</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Paul Carpenter</u>	, Member
<u>Anne Baker*</u>	, Member

*For Gray Davis, per Government Code section 7.9