



87-SBE-073

BEFORE THE STATE BOARD OF **EQUALIZATION**
OF THE STATE OF CALIFORNIA

In the Matter of the **Appeal of**)
RITCHIE SCOTT **WOOD**) No. **82R-1651-KP**

For Appellant: John Gigounas
Attorney at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

This appeal is made pursuant to section 19507, subdivision (a), ^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Ritchie Scott Wood for refund of a personal income tax in the amount of \$8,835 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 year in issue.

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

On December 19, 1981, appellant was involved in a three-car accident in Sacramento, California. A subsequent investigation of the accident resulted in California Highway Patrol officers discovering over two pounds of cocaine and \$4,000 in cash under appellant's control. Appellant was arrested and subsequently pled guilty to one count of possession of a controlled substance with intent to sell. Appellant received a misdemeanor sentence which included probation.

Upon being informed of the above events and discoveries, respondent determined that appellant had unreported income from the sale of narcotics, the tax of which would be jeopardized by delay. As respondent and law enforcement officials were unaware of appellant's involvement in the narcotics trade prior to his arrest, respondent estimated appellant's 1981 income by use of the expenditures method of income reconstruction. Respondent determined that appellant had spent a total of \$80,000 for the cocaine and that appellant's living expenses totalled \$1,000 per month, for a total income of \$92,000. Following the issuance of the assessment at issue based upon the above income estimation, appellant submitted a petition for a reassessment. Prior to a decision on the petition, appellant admitted to having \$3,000 a month in expenses. Eventually, respondent affirmed its assessment and 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). 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. § 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

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to prove that a reasonable reconstruction of income is erroneous. (Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

To arrive at its estimate of income, respondent used the cash expenditures 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. (Appeal of Fred Dale Stegman, Cal. St. Bd. of Equal., Jan. 8, 1985.) 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 unreported income rather than accumulating it. (Appeal of Fred Dale Stegman, supra.) 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 (1) to resources on hand at the beginning of the period, (2) to nontaxable income received during the period, and (3) to 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 United States** 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 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

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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." (v. United States, supra, 398 F.2d at 565.) Proof is ch lacking, the government's determinations are arbitrary and cannot be sustained. (Taglianetti v. United States, supra; Thomas v. Commissioner, supra.)

Neither party has provided us with a specific dollar opening net worth for 1981. As respondent has used the cash expenditures method of income reconstruction, however, the need to establish a specific opening net worth is diminished. (Taglianetti v. United States, supra.) If the circumstances of an appeal provide a basis for determining a reasonable approximation of an opening net worth, we will uphold its validity. (See Appeal of Dennis and Cynthia-Arnold, Cal. St. Bd. of Equal., May 6, 1986, fn. 2.)

Respondent has provided us with a telling account of appellant's finances by submitting appellant's divorce records. On January 27, 1981, appellant and his wife of 12 years, legally separated. Part of that stipulation of separation required the parties to hold all of the community property in a state of limbo until a final decree of divorce was entered. Consequently, neither party was able to convey or convert any property, real or personal, during 1981.

On February 3, 1982, the final divorce decree was filed. The provisions of the decree stated that appellant was to receive, as settlement, the family home, 40 acres of property, a 1977 motorcycle, a 1942 car, a jet ski, tools, a trailer, furniture, and his personal effects and property. As there is no mention of specific separate property acquired during or before the marriage, we assume that the only property owned by appellant prior to 1981 was community property covered by the divorce decree. (See Cal. Civ. Code, § 4800 et seq.) This assumption of the lack of separate property is bolstered by the fact that appellant and his ex-wife were married relatively young, just after appellant had finished his enlistment in the army. Furthermore, appellant and his wife were married for 12 years, and any property acquired during a marriage in California is presumed to be community property. (Cal. Civ. Code, Sec. 4800, et seq.) Taking these facts and presumptions into consideration, plus the preclusion on both parties from disposing of any property during 1981, we find that appellant's property

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in no way contributed to his expenditures for 1981. Consequently, any expenditures or increases in net **worth**, may be presumed to have been made with or attributed to income received during 1981. (See Taqlianetti v. United States, supra.) Therefore, the only remaining question is what income may be attributed to appellant during 1981.

Appellant admitted to \$3,000 a month in **personal** expenses for a total of **\$36,000** for 1981. Appellant was also found to have under his control during 1981, two pounds of cocaine costing \$80,000. While appellant has subsequently denied **ownership** of the narcotics, we note that he did plead guilty to possession of the cocaine for sale. Furthermore, appellant's contention that he was only a courier of the drugs has **not been** supported by any evidence other than his bald assertion. (See Appeal of Marcel C. Robles, supra.) Since appellant did not have any prior-owned assets upon which to draw to purchase the cocaine, we find that appellant must have bought the cocaine with taxable income he received during 1981. Finally, while appellant takes issue with respondent's estimation that the cocaine cost **\$40,000** a pound, a figure based upon Department of Justice estimates of drug costs, he has provided nothing to dispute its accuracy. Consequently, we find that appellant has failed to carry his burden of proving that respondent was erroneous in determining that appellant made an additional \$80,000 in income which **he spent** on acquiring the cocaine found in his possession as **described** above. (See Appeal of Marcel C. Robles, supra.)

By virtue of appellant's admission as to the \$36,000 in expenses, and by attributing another \$80,000 as the basis in the cocaine to appellant's 1981 **income**, we find that respondent's determination of appellant's unreported income of \$92,000 for 1981 is based upon facts substantiated by the record on appeal. Furthermore, we find that appellant **has** failed to produce evidence sufficient to satisfy his burden of proving that respondent was erroneous in its determination. Accordingly, **respondent's** action in this matter must be sustained.

