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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:

) **SECOND HEARING SUMMARY**  
) **PERSONAL INCOME TAX APPEAL**

12 **NEMAT MALEKSALEHI AND**

) Case No. 395817

13 **MARYAM MALEKSALEHI**

14 \_\_\_\_\_  
15 Year \_\_\_\_\_ For Claim  
16 2001 \$115,870 Refund

17 Representing the Parties:

18 For Appellants: Jerom e A. Bellotti, Certified Public Accountant  
19 Barzin Barry Sabahat, Attorney at Law  
20 For Franchise Tax Board: Raul A. Escatel, Tax Counsel

22 QUESTION: Whether appellants have shown that they are entitled to deduct certain payments  
23 that they made in connection with a plea bargain with the federal government.

24 HEARING SUMMARY

25 Background

26 At the conclusion of the first hearing on the instant matter that occurred on December 11,  
27 2007, the Board ordered additional briefing regarding the following issues (as well as other issues that  
28 staff considered useful for the Board’s deliberations): (1) the distinction between fines and “restitution;”

1 (2) the relationship among Internal Revenue Code (“IRC”) section 162, IRC section 165, and their  
2 putative California counterparts, including Revenue and Taxation Code (“R&TC”) 17282; (3) the  
3 applicability of the *Talley Industries* cases and *Waldman v. Commissioner* (1987) 88 T.C. 1384  
4 (“*Waldman*”);<sup>1</sup> and (4) the possible treatment of a “restitution” payment as an “adjustment to income,”  
5 as opposed to a deduction of an ordinary and necessary business expense. In addition, the Board  
6 ordered that staff request any additional documentation from the parties that would complete the record  
7 of the relevant events that occurred. After a statement from appellant’s<sup>2</sup> representative at the first  
8 hearing that, in alleged contrast with his interactions with respondent, the Internal Revenue Service  
9 (“IRS”) worked with him both extensively and cooperatively to develop information that ultimately led  
10 the IRS to the conclusion that the amount at issue was deductible in its entirety, the Board further  
11 ordered staff to ensure that the requested documents included relevant documents from appellant’s  
12 proceedings before the IRS. On January 18, 2008, staff sent the attached request for additional briefing  
13 (“Exhibit B”) to the parties.

14 Appellant responded to the Board’s request for additional briefing on April 23, 2008. In  
15 his brief, appellant continues to take the position that IRC section 162(f) does not apply to disallow the  
16 deduction of the amount at issue here. Appellant argues that the Plea Agreement and the 3<sup>rd</sup> Amended  
17 Judgment in his federal criminal case (both attached to that brief as exhibits) supports that position  
18 because they allegedly show that the only fines or penalties for purposes of IRC section 162(f) that the  
19 federal government assessed against appellant was a “special assessment” of \$400 on page seven of the  
20 Plea Agreement and an “assessment” of \$100 under a category for “criminal monetary penalties” on  
21 page six of the 3<sup>rd</sup> Amended Judgment, which also indicated “none” for “fines, and “none” for  
22 “restitution.” In appellant’s view, the amount at issue (\$1,406,255) is compensatory, and therefore  
23 deductible under IRC section 162(a), because it is allegedly not “monetary penalties for restitution”  
24 assessed against appellant. Appellant distinguishes *Waldman* and *Southern Pacific Transportation Co.*  
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26 <sup>1</sup> The *Talley Industries* cases are three related cases that will be cited and discussed in the text of the hearing summary after  
27 the discussion of *Waldman*.

28 <sup>2</sup> As mentioned in the hearing summary for the first hearing in this matter (“Exhibit A”), this hearing summary will generally  
refer to appellant-husband as “appellant” and will sometimes refer to appellants as “appellant.”

1 *v. Commissioner* (1980) 75 T.C. 497 (“*Southern Pacific*”) on the basis that the amounts assessed against  
2 the taxpayers in those cases were fines and penalties that were properly disallowed under IRC section  
3 162(f) while the amount at issue here was allegedly not such a fine or penalty. In addition, appellant  
4 cites the *Talley Industries* cases to support the proposition that the amount at issue was an ordinary and  
5 necessary business expense under IRC section 162(a).

6 Appellant has also provided, among other documents, copies of the “Examiner’s work  
7 papers pertaining to the adjustment to Schedule E [of appellant’s tax return for 2001]” (attached to  
8 appellant’s brief as an exhibit). In this document, the examiner for the IRS allowed under IRC section  
9 165 the deduction of the entire amount at issue (\$1,406,255). He stated that the amount represented  
10 “restitution payments” to HUD as follows: (1) \$1 million with respect to appellant’s property in  
11 California, (2) \$220,658 with respect to his property in Louisiana, and (3) \$185,597 with respect to his  
12 property in Wyoming. In connection with his conclusion regarding the deductibility of the amount at  
13 issue, the examiner discusses information from various sources, but it is unclear exactly how this  
14 information resulted in that conclusion. In addition, appellant provided a letter from the IRS, dated  
15 April 8, 2008, (attached to appellant’s brief as an exhibit) in which the IRS states that appellant’s request  
16 for an “Explanation of Adjustments” cannot be met because it was unable to locate such a document.

17 Finally, appellant’s brief reiterates his position at the first hearing in this matter that the  
18 “adjustment to income” issue is irrelevant here because that concept applies only to accrual basis  
19 taxpayers while appellant is a cash basis taxpayer. Appellant alleges that inappropriate consequences  
20 would result if the “adjustment to income” concept was applied to him and, in essence, disclaims any  
21 reliance on it.

22 In its reply brief, respondent’s essential concern is summarized in its statement “[t]his is  
23 not a case of a mere overpayment by HUD as appellant claims, rather this is a case of Appellant illegally  
24 obtaining money by defrauding the United States government.” Respondent argues that appellant’s  
25 claimed deduction is barred by IRC section 162(f) because the amount at issue was paid pursuant to a  
26 criminal conviction. In support of that argument, respondent relies upon Treasury Regulation section  
27 (“Treasury Regulation”) 1.162-21(b)(1)(i), which provides that, for purposes of IRC section 162(f), a  
28 “fine or similar penalty” includes an amount “[p]aid pursuant to conviction or a plea of guilty or *nolo*

1 *contendere* for a crime (felony or misdemeanor) in a criminal proceeding.” Respondent argues that  
2 appellant misplaces what respondent’s characterizes as appellant’s reliance on Example (1) of Treasury  
3 Regulation 1.162(c), which provides as follows:

4 **(c.) Examples.** The application of this section may be illustrated by the following  
5 examples:

6 *Example (1).* M Corp. was indicted under section 1 of the Sherman Anti-Trust  
7 Act (15 U.S.C. 1) for fixing and maintaining prices of certain electrical  
8 products. M Corp. was convicted and was fined \$50,000. The United  
9 States sued M. Corp. under section 4A of the Clayton Act. (15 U.S.C. 15a)  
10 for \$100,000, the amount of the actual damages resulting from the price  
11 fixing of which M Corp. was convicted. Pursuant to a final judgment  
12 entered in the civil action, M Corp. paid the United States \$100,000 in  
13 damages. Section 162(f) precludes M Corp. from deducting the fine of  
14 \$50,000 as a trade or business expense. Section 162(f) does not preclude  
15 it from deducting the \$100,000 paid to the United States as actual  
16 damages.

17 Respondent states that Example (1) of Treasury Regulation 1.162(c) is inapplicable here  
18 because “[a]ppellant’s restitution was ordered pursuant to a criminal proceeding.” Respondent states  
19 further that all of the examples under Treasury Regulation 1.162(c) are concerned with the issue whether  
20 “civil penalties” are “fines or penalties” for purposes of IRC section 162(f). It cites Treasury Regulation  
21 1.162-21(b)(1)(i) in support of that statement. However, respondent probably meant to cite Treasury  
22 Regulation 1.162-21(b)(1)(ii), which provides in pertinent part that, for purposes of IRC section 162(f),  
23 a “fine or penalty” includes an amount “[p]aid as a civil penalty imposed by Federal, State, or local  
24 law.” In any event, respondent’s argument appears to be predicated on the position that IRC section  
25 162(f) prohibits the deduction of an amount paid by the defendant under the direction, control, or any  
26 kind of broad influence of a court in a criminal proceeding in which there was a result adverse to the  
27 defendant.

28 In its discussion of the *Talley Industries* cases and *Waldman*, respondent argues that those  
cases support its view that IRC section 162(f) prohibits the deduction of the amount at issue. With  
regard to the *Talley Industries* cases, respondent emphasizes that the amount of \$1,185 which was paid  
pursuant to the criminal judgment against the taxpayer was acknowledged not to be deductible as a “fine  
or similar penalty” under IRC section 162(f). With regard to the other amounts that were treated in  
those cases as deductible compensation, respondent attempts to distinguish those amounts on the basis

1 that they were paid under particular civil statutes and their payment was explicitly designated as  
2 compensation.

3 With regard to *Waldman*, respondent states that if the taxpayer in that matter had not pled  
4 guilty, “the court could not have ordered restitution.” Relying on the reasoning in *Waldman*, respondent  
5 argues that appellant’s payment was not deductible under Treasury Regulation 1.162-21(b)(1)(i) because  
6 it was paid pursuant to his plea of guilty. In *Waldman*, the taxpayer was a mortgage broker in Marina  
7 Del Rey, California, who was charged with 29 counts of conspiracy to commit grand theft in connection  
8 with that business. The taxpayer pled guilty to one count of conspiracy to commit grand theft, and the  
9 Los Angeles County Superior Court (“court”) dismissed the remaining 28 counts. The court sentenced  
10 the taxpayer to 1 to 10 years in prison but stayed execution of the sentence on condition that he pay  
11 \$28,500 in restitution to his victims. The taxpayer deducted that amount on his tax return as a legal or  
12 professional fee, and the IRS disallowed his deduction. (*Waldman v. Commissioner, supra*, 88 T.C. at  
13 pp. 1385-1386.)

14 The Tax Court concluded under Regulation 1.162-21(b)(1)(i) that the taxpayer’s payment  
15 in restitution was a “fine or similar penalty” under IRC section 162(f) and was, as a result, not  
16 deductible. The court reasoned that the taxpayer’s restitution was paid pursuant to his plea of guilty, and  
17 thus a “fine or similar penalty” under that regulation, because if the taxpayer had pled not guilty and  
18 been subsequently acquitted, the court could not have ordered payment of restitution. (*Waldman v.*  
19 *Commissioner, supra*, 88 T.C. at pp. 1386-1387.)

20 After resolving the matter under Treasury Regulation 1.162-21(b)(1)(i), the court noted  
21 that neither party had referred to that regulation but, instead, contended that “restitution paid pursuant to  
22 a criminal conviction is analogous to a civil penalty.” The court characterized the foregoing contention  
23 of the parties as a “test” but stated that it was unnecessary to apply that “test” in view of the conclusion  
24 that it reached under Treasury Regulation 1.162-21(b)(1)(i). However, the court further stated that the  
25 taxpayer would not have prevailed under that “test” and provided an analysis of the taxpayer’s case  
26 under it. Citing *Southern Pacific Transportation Co. v. Commissioner, supra*, 75 T.C. at pp. 646-654  
27 and *Huff v. Commissioner* (1983) 80 T.C. 804, 824, the court pointed out that it had held previously that  
28 IRC section 162(f) prohibited the deduction of civil penalties “imposed for purposes of enforcing the

1 law and as punishment for the violation thereof” but had also held that some civil payments, even if they  
2 are labeled penalties, are deductible under that section if “imposed to encourage prompt compliance  
3 with the law or as a remedial measure to compensate another party.” (*Waldman v. Commissioner*,  
4 *supra*, 88 T.C. at p. 1387.) Citing *S&B Restaurant, Inc. v. Commissioner* (1980) 73 T.C. 1226, at page  
5 1232, the court then stated that when a payment ultimately serves each of the purposes of law  
6 enforcement (nondeductible) and compensation (deductible), the task of the court is “to determine which  
7 purpose the payment was designed to serve.” (*Waldman v. Commissioner, supra.*) In rejecting the  
8 taxpayer’s contention that his restitution payments were compensatory, the court relied upon a number  
9 of California Supreme Court cases to the effect that (1) an order suspending sentence is an informal  
10 grant of probation in California; (2) rehabilitation of the criminal is the major goal of California penal  
11 provisions that authorize restitution as a condition of probation; and (3) restitution is generally  
12 considered a deterrent to future criminality and “need not be limited to the transactions or amounts for  
13 which the defendant is actually convicted.” The court finally concluded that the taxpayer’s obligation to  
14 pay restitution was “imposed for purposes of enforcing the law” and, for that reason, was nondeductible  
15 under IRC section 162(f). (*Waldman v. Commissioner, supra*, at pp. 1387-1388.)

16 The *Talley Industries* cases were decided after *Waldman*. In those cases, the taxpayers  
17 performed work under various contracts with the United States Navy. The taxpayers were indicted  
18 under a number of federal criminal statutes for filing false claims (“mischarging”) with respect to those  
19 contracts. Subsequently, one of the taxpayers entered into a plea agreement with the federal government  
20 under which it pled guilty, under one of those statutes, to ten counts of submitting false claims in return  
21 for which the federal government agreed to drop the remaining counts and prosecution of some of its  
22 officers. The plea agreement was accepted by the federal district court with jurisdiction over the matter.  
23 That court then entered a Judgment and Probation Commitment order, which stated that the taxpayer  
24 would pay a fine of \$100,000 (\$10,000 for each of the ten counts to which it pled guilty and that “the  
25 defendant shall make full restitution for all losses, to be determined by the U.S. Navy at a later date.”  
26 (*Talley Industries Inc. v. Commission* T.C. Memo 1994-608 (“*Talley Industries I*”).)

27 During negotiations between the taxpayer and the federal government regarding the  
28 taxpayer’s civil liability for filing false claims, it became apparent that the taxpayer was exposed to

1 potential liability under the federal Truth in Negotiating Act (or “TINA”), the False Claims Act (or  
2 “FCA”), and a common law cause of action for breach of contract. It was agreed that the losses  
3 sustained by the Navy under the ten counts of mischarging to which the taxpayer pled guilty was \$1,885,  
4 but the losses to the Navy for the other false claims submitted by the taxpayer were originally estimated  
5 by the federal government to be between \$240,000 and \$358,000. Later, the federal government stated  
6 that the actual losses suffered by the Navy were estimated to be \$1,560,000. At that time, the federal  
7 government offered to settle the matter for \$2,500,000 (less \$600,000 paid as part of an interim  
8 agreement). After a written counteroffer by the taxpayers of \$2,000,000 that contained language  
9 expressing its view that the payment of that amount represented “double damages,” the federal  
10 government made its own written counteroffer of \$2,500,000 (less the payment of \$600,000).  
11 Ultimately, the matter settled in a manner consistent with the federal government’s final counteroffer,  
12 and the settlement agreement provided that “the \$2.5 million payment will satisfy [the taxpayer’s]  
13 obligation to provide restitution under the Judgment and Probation Commitment Order.” (*Talley*  
14 *Industries I, supra.*)

15 On their tax return, the taxpayers deducted the amount of \$2,500,000 as an ordinary and  
16 necessary business expense under IRC section 162(a). The IRS disallowed the claimed deduction under  
17 IRC section 162(f). The matter appeared before the Tax Court on cross motions for summary judgment,  
18 and the issue to be decided was whether the amount was a “fine or similar penalty” under IRC section  
19 162(f). Relying upon *Waldman* and Treasury Regulation 1.162 – 21(b)(1)(i), the federal government  
20 took the position that the whole amount was not deductible under IRC section 162(f) because payment  
21 of that amount was made in satisfaction of the order entered in the criminal proceedings. The taxpayers,  
22 on the other hand, relied on *Southern Pacific* to support its position that payment of the amount was  
23 compensatory rather than punitive. The Tax Court concluded that the amount of \$1,885 paid with  
24 respect to the ten counts to which the taxpayer pled guilty was an amount paid pursuant to a plea of  
25 guilty for a crime under Treasury Regulation 162-21(b)(1)(i) and, for that reason, was a nondeductible  
26 “fine or similar penalty” under IRS section 162(f). (*Talley Industries I, supra.*)

27 With regard to the remaining amount of the \$2.5 million, the Tax Court concluded that it  
28 was compensatory for the purposes of IRC section 162(f). In reaching its conclusion, the Tax Court

1 reviewed the history and purpose of the TINA and the FCA, as well as the facts and circumstances  
2 surrounding the settlement agreement. In evaluating these facts and circumstances surrounding the  
3 settlement agreement, the Tax Court observed that, if the actual losses sustained by the Navy were at  
4 least \$1,560,000, the amount paid of \$2.5 million dollars did not represent “double damages” for  
5 purposes of the FCA. As a result, in the Tax Court’s view, the amount paid “wasn’t intended to be penal  
6 or punitive, but rather was compensatory in nature.” Finally, the Tax Court stated that if an amount paid  
7 to a government as an ordinary and necessary business expense is not a “fine or similar penalty” under  
8 IRC section 162(f), the deduction of that amount is permitted under IRC section 162(a) regardless of  
9 other public policy considerations. (*Talley Industries I, supra.*)

10 On appeal the Ninth Circuit Court of Appeals (9<sup>th</sup> Circuit) reversed the order of the Tax  
11 Court granting summary judgment in favor of the taxpayers and remanded the matter to the Tax Court.  
12 (*Talley Industries Inc. v. Commissioner* (9<sup>th</sup> Cir. 1997) 116 F.3d 382, 387. (*Talley Industries II.*) The  
13 Ninth Circuit pointed out that the parties there did not dispute that the amount of \$1,885 paid in  
14 restitution was not deductible or that the \$1.56 million portion of the settlement (less the restitution  
15 payment of \$1,885) constitutes compensation to the Navy for its losses and, for that reason, was  
16 deductible. However, the Ninth Circuit concluded that there was a genuine issue of material fact  
17 regarding the characterization and purpose of the remaining portion of the settlement (\$940,000 =  
18 \$2,500,000 - \$1,560,000). (*Talley Industries Inc. v. Commissioner, supra*, 116 F.3d at p. 387) In  
19 reaching that conclusion, the Ninth Circuit rejected a number of the Tax Court’s rationales for granting  
20 summary judgment to the taxpayer, including the rationale that, during settlement negotiations, the  
21 government “never suggested that it was attempting to exact a civil penalty from [the taxpayer].” In that  
22 regard, the Ninth Circuit pointed out that the rationale wrongly assumes that the government has the  
23 burden of characterizing the payment while, in fact, the taxpayer has the burden to establish entitlement  
24 to a particular deduction and pays the consequences if evidence to establish the deduction is lacking.  
25 (*Talley Industries Inc. v. Commissioner, supra.*) On remand, the Tax Court considered 27 pages of  
26 documentary evidence and the testimony of six witnesses, all of whom had been involved in negotiating  
27 the settlement agreement, in concluding that the taxpayers had failed to establish their entitlement to the  
28 deduction of the amount of \$940,000. In reaching its conclusion, the Tax Court noted that the parties

1 executed a settlement agreement that is silent on the characterization of the settlement payments and that  
2 the taxpayers did not clarify the matter. (*Talley Industries Inc. v. Commissioner* T.C. Memo 1999-200)  
3 (*Talley Industries III*’).)

4 Respondent essentially addresses the “adjustment to income” issue by repeating its  
5 arguments made in previous briefing regarding the “claim of right” doctrine, as embodied in IRC section  
6 1341. Respondent also states that R&TC section 17282 is not patterned after any federal statute,  
7 including IRC section 162(f), but appears to argue that there are similarities between that statute and  
8 IRC section 280E even though, in its view, the federal statute is more restrictive in its application. In  
9 addition, respondent points out that the IRS resolved its dispute with appellant under IRC section 165,  
10 rather than IRC section 162, and again concludes that IRC section 162(f) prohibits the deduction  
11 claimed by appellant.<sup>3</sup>

12 In appellant’s supplemental brief (October 20, 2008), appellant discusses the term  
13 “restitution” as it is used in various general contexts in an apparent attempt to show that the payment at  
14 issue was compensatory for purposes of IRC section 162(f). However, appellant cites no authority in his  
15 brief that discusses the term “restitution” in the context of that statute. In order to show that the payment  
16 at issue was not “ordered pursuant to a criminal proceeding” for purposes of Treasury Regulation 1.162-  
17 21(b)(1)(i), respondent points out that the Plea Agreement under which he agreed to make “restitution”  
18 of the payment at issue only contained a range of possible criminal punishments and did not impose any  
19 such punishments. He also discusses other facts of varying degrees of relevance in an attempt to  
20 attenuate the relationship between the payment at issue and the criminal sanctions imposed upon him.

21 Law \_\_\_\_\_

22 IRC section 162(a) provides generally that a deduction shall be allowed for all the  
23 ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any  
24 trade or business. IRC section 162(f) provides that no deduction shall be allowed under subdivision (a)  
25 for any fine or similar penalty paid to a government for the violation of any law. IRC section 165(a)  
26 provides that a deduction shall be allowed for any loss sustained during the taxable year and for which  
27 \_\_\_\_\_

28 <sup>3</sup> IRC section 280E provides essentially that no deduction or credit shall be allowed for any amount paid or incurred in carrying on any trade or business if that trade or business consists of trafficking in certain illegal drugs.

1 compensation has not been received by insurance or otherwise. IRC section 165(c)(2) provides that, in  
2 the case of an individual, the deduction under subsection (a) of section 165 shall be limited to losses  
3 incurred in any transaction entered into for profit, though not connected with a trade or business.

4 Treasury Regulation 1.162-21(b)(1)(i) provides that, for purposes of IRC section 162(f),  
5 a fine or similar penalty includes an amount paid pursuant to conviction or plea of guilty or *nolo*  
6 *contendere* for a crime (felony or misdemeanor) in a criminal proceeding. Treasury Regulation 1.162-  
7 21(b)(1)(ii) provides, in pertinent part, that a fine or similar penalty includes an amount paid as a civil  
8 penalty imposed by federal, state, or local law. Treasury Regulation 1.162-21(b)(1)(iii) provides that a  
9 fine or similar penalty includes an amount paid in settlement of the taxpayer's actual or potential  
10 liability for a fine or penalty (civil or criminal). Treasury Regulation 1.162-21(b)(2) provides, in  
11 pertinent part, that compensatory damages, including damages under section 4A of the Clayton Act (15  
12 U.S.C. 15a, as amended), paid to a government do not constitute a fine or penalty.

13 R&TC section 17282 provides, in pertinent part, that no deduction shall be allowed to  
14 any taxpayer on any of his gross income directly derived from illegal activities, as defined in various  
15 provisions of the Penal and Health and Safety Codes, or from his gross income derived from any other  
16 activities that directly lead to promote or to further, or are directly connected with those illegal activities.  
17 IRC section 280E provides, in essence, that no deduction or credit shall be allowed for any amount paid  
18 or incurred in carrying on any trade or business if that trade or business consists of trafficking in certain  
19 illegal drugs.

20 IRC section 1341(a) provides generally that if (1) an item was included in gross income  
21 for a previous taxable year because it appeared that the taxpayer had an unrestricted right to such item,  
22 (2) a deduction is allowable for the taxable year because it was established after the close of such  
23 previous taxable year that the taxpayer did not have an unrestricted right to such item, and (3) the  
24 amount of the deduction exceeds \$3000, then the tax for the taxable year shall be the lesser of the tax for  
25 the taxable year computed with such deduction or an amount equal to the tax without such deduction  
26 less the decrease in tax for the previous taxable year that would result solely from the exclusion of such  
27 item from the gross income for the previous taxable year.

28 It is well settled that a presumption of correctness attends respondent's determinations as

1 to issues of fact and that appellant has the burden of proving such determinations erroneous. (*Appeal of*  
2 *Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is, however, a  
3 rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary.  
4 (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) Respondent’s determination cannot, however, be  
5 successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent, and  
6 relevant evidence as to the issues in dispute. (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*)

7           Income tax deductions are a matter of legislative grace, and the burden is on the taxpayer  
8 to show by competent evidence that he is entitled to the deductions that he claimed. (*Appeal of*  
9 *James C. and Monablanché A. Walsh*, 75-SBE-073, Oct. 20, 1975.) To carry that burden, the taxpayer  
10 must point to an applicable statute and show by credible evidence that he comes within its terms.  
11 (*Appeal of Robert R. Telles*, 86-SBE-061.) Unsupported assertions by the taxpayer are not sufficient to  
12 carry his burden of proof. (*Appeal of Robert R. Telles, supra.*) The failure of a taxpayer to produce  
13 evidence within his control which, if true, would be favorable to him, gives rise to the presumption that,  
14 if the evidence were produced, the evidence would be unfavorable to him. (*Appeal of Don A. Cookston*,  
15 83-SBE-048, Jan. 3, 1983.)

16           The Board has stated that it is not bound to follow IRS decisions that it believes to be  
17 erroneous. (*Appeal of Der Wienerschnitzel International, Inc.*, 79-SBE-063, Apr. 10, 1979.)

#### 18 STAFF COMMENTS

##### 19 *Stephens Case*

20           As part of its independent research, staff has located a case in which both the Tax Court  
21 and the Second Circuit Court of Appeals (“Second Circuit”) agreed that the deductibility of a restitution  
22 payment should be governed by IRC section 165 (c)(2) rather than section 162. (*Stephens v.*  
23 *Commissioner* (2<sup>nd</sup> Cir. 1990) 905 F. 2d 667, rev’g 93 T.C. 108.) In that matter, the taxpayer was  
24 indicted for participation in a scheme to defraud Raytheon. After a trial, he was convicted of four counts  
25 of wire fraud, one count of transportation of the proceeds of fraud in interstate commerce, and one count  
26 of conspiracy. On the count of wire fraud, the taxpayer was sentenced to five years imprisonment and a  
27 fine of \$5,000. On the remaining three counts of wire fraud, the taxpayer was sentenced to five years  
28 imprisonment and a fine of \$1,000 on each count. On the conspiracy count, the taxpayer was sentenced

1 to a prison term of five years and a fine of \$10,000. On the count of the interstate transportation of the  
2 proceeds of fraud, the taxpayer was sentenced to a prison term of five years and a fine of \$5,000. The  
3 execution of the prison term on the last count was suspended, and appellant was placed on probation for  
4 five years on the condition that he make restitution to Raytheon in the amount of \$1 million. (*Stephen v.*  
5 *Commissioner, supra*, 93 T.C. p 105.) The IRS disallowed appellant’s deduction of that amount under  
6 IRC Section 162(f).

7 At trial, the taxpayer took the position that the restitution payment was deductible under  
8 IRC Section 165. The IRS took the position that IRC section 162(f) precluded the deduction. In the  
9 alternative, the IRS argued in part that if the deductibility of the restitution payment is governed by IRC  
10 Section 165, public policy would prevent the deductibility of the restitution payment. (*Stephens v.*  
11 *Commissioner, supra*.) In concluding that IRC section 165 was the governing statute, the Tax Court  
12 stated that “[t]he decided cases establish that a restitution payment, such as involved herein, is not an  
13 ‘ordinary and necessary’ business expense as required by IRC section 162(a) but rather gives rise to a  
14 loss in a ‘transaction entered into for profit’ under section 165(c)(2). [Citing *Mannette v. Commissioner*  
15 (1977) 69 T.C. 990, 992-994 and other Tax Court cases]” (*Stephens v. Commissioner, supra*, 93 T.C.  
16 pp. 111-112.)

17 After concluding that IRC section 165 (c)(2), rather than section 162(f), was the  
18 governing statute in that matter, the Tax Court further concluded the standards for the applicability of  
19 IRC section 162(f) were relevant to the deductibility of an amount under IRC section 165(c)(2). It also  
20 stated that it was not necessary in that matter to decide whether the public policy considerations  
21 involved in the application of IRC section 165(c)(2) are broader than those encompassed by section  
22 162(f). (*Stephens v. Commissioner, supra*, 93 TC. at p. 112.) Relying upon Treasury Regulation 1.162-  
23 21(b)(1)(i), the Tax Court held that the deduction of the restitution payment should be disallowed  
24 because it “was made as the result of a criminal conviction and that it was ordered in lieu of additional  
25 prison term and as a condition of probation.” The Tax Court commented in that regard that the  
26 reimbursement of loss aspect was merely incidental to the consequence of the taxpayer’s criminal  
27 activities. (*Stephens v. Commissioner, supra*, 93 TC. at p. 113.)

28 The Second Circuit reversed the Tax Court on the ground that allowing the deduction of

1 the restitution payment “would not severely and immediately frustrate a sharply defined national or state  
2 policy.” (*Stephens v. Commissioner, supra*, 905 F.2d at p. 670.) After finding the cases discussing the  
3 scope of the public policy exception under IRC section 165 to be “insufficiently decisive,” the Second  
4 Circuit turned to IRC section 162(f) as “an aid in applying IRC section 165.” (*Stephens v.*  
5 *Commissioner, supra*, at p. 672.) One of the considerations of the Second Circuit in concluding that  
6 allowing a deduction for the restitution would not “severely and immediately frustrate public policy”  
7 was its finding that the restitution payment was a remedial measure intended to compensate Raytheon  
8 rather than a “fine or similar penalty” under IRC section 162 (f), even though the taxpayer paid the  
9 embezzled funds as a condition of his probation. (*Stephens v. Commissioner, supra*, 95 F.2d at pp. 672-  
10 673.) In support of its finding, the Second Circuit states that it reviewed the record of the sentencing  
11 proceeding and, after noting that a judge had allowed the five-year sentences on all counts (except for  
12 the one that she had suspended) to run concurrently, concluded that the judge settled on a five-year  
13 prison term and a fine as the appropriate sentence and added the suspended five-year term as a  
14 mechanism to “get Raytheon its money back.” The Second Circuit distinguished *Waldman* on the basis  
15 that the entire sentence of the defendant there was suspended on the condition that he make restitution,  
16 while the sentence of the taxpayer in the *Stephens* case consisted of a prison term, fines, and an order to  
17 make restitution. (*Stephens v. Commissioner, supra*, 905 F.2d. at p. 673.) In view of the foregoing, the  
18 Second Circuit held that while fines the taxpayer paid as part of his punishment were clearly not  
19 deductible, the restitution payment was compensatory, and, for that reason, deductible. (*Stephens v.*  
20 *Commissioner, supra*.)

21 Hearing\_\_\_\_\_

22 At the hearing, the parties should be prepared to discuss the applicability of the *Waldman*  
23 case, the *Talley Industries* case, and the *Stephens* cases to the facts in this matter. In particular, the  
24 parties should address their discussion to the following stated facts in paragraph 2 of the Plea Agreement  
25 and the issues associated with them: (1) California Case-With regard to the ‘restitution payment’ of \$1  
26 million, was part of that amount a deductible compensatory payment for the checks of \$58,108 and  
27 \$187,148 mentioned under that case. Was the difference between \$1 million and the sum of the  
28 amounts of those checks (\$854,944) such a compensatory payment? (2) Louisiana Case-With regard to

1 the “restitution payment” of \$220,658, was part of that amount a deductible compensatory payment for  
2 the check of \$35,285 mentioned in that case? Was the difference between \$220,658 and the amount of  
3 that check (\$185,373) such a payment? What interpretation and weight should be given to the statement  
4 at the end of the discussion of the case that “I agree that the total loss based upon my fraudulent  
5 activities in connection to the [Louisiana property] is \$220,658?” (3) Wyoming Case-With regard to the  
6 “restitution payment” of \$185,597, was that amount a deductible compensatory payment? What  
7 interpretation and weight should be given to the statement at the end of the case that “I agree that the  
8 total loss to HUD based upon my fraudulent activities in connection with the [Wyoming property] is  
9 \$185,597?”

10 In that regard, the parties should also address the relationship of the foregoing cases,  
11 stated facts, and associated issues to the discussion in paragraphs eight and fourteen of the reduction in  
12 appellants’ recommended imprisonment. In particular, the parties should discuss the implications of the  
13 statement in paragraph fourteen that the basis for the reduction in his recommended imprisonment is  
14 “[t]o reflect the intent of the parties to achieve a global settlement with Santa Clara Superior Court case  
15 numbers 193306 and 208018.”

16 With regard to his statements about the favorable result that he achieved with the IRS,  
17 appellant should provide at least 14 days prior to the hearing any evidence and related legal argument  
18 presented to the IRS purporting to show that the payment at issue was compensatory under IRC section  
19 162(f), any written correspondence from the IRS about the proper characterization of the payment under  
20 that section, and any internal IRS documents discussing or otherwise providing relevant information  
21 about the proper characterization of the payment. In addition, appellant should provide at that time any  
22 other documents, including (1) appellant’s correspondence with HUD and other federal and state  
23 agencies, (2) appellant’s correspondence with, and internal documents of, the court issuing the 3<sup>rd</sup>  
24 Amended Judgment, and (3) similar documents from California courts that discuss or otherwise provide

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26 ///  
27 ///  
28 ///

1 relevant information about the proper characterization of the payment.<sup>4</sup> Appellant should also provide  
2 affidavits or direct testimony from his criminal or other attorneys regarding the negotiation of the Plea  
3 Agreement and issuance of the 3<sup>rd</sup> Amended Judgment. Finally, appellant should be prepared to testify  
4 at the hearing.

5 Next, staff notes that it appears that R&TC section 17282 may not be relevant to the  
6 instant matter because that section (like IRC section 280E) is concerned with illegal gross income  
7 arising from the violation of specific criminal statutes<sup>5</sup> against which otherwise proper deductions may  
8 not be taken, while the concern here is with the appropriateness of the deductions themselves and not  
9 with the gross income of appellant. Finally, respondent may wish to clarify why the “claim of right”  
10 doctrine, as embodied in IRC section 1341, is relevant to the instant matter. Staff notes that IRC section  
11 1341 is a narrowly applied statute which describes how tax is computed for a taxable year when it  
12 appeared to the taxpayer that he had a “claim of right” to income in a previous year and was later shown  
13 to be wrong. Respondent should be prepared to explain, with appropriate citation to authority, why even  
14 if appellant does not satisfy all of the requirements of IRC section 1341, such as believing that he  
15 received the amount at issue under a “claim of right,” it necessarily follows that he is not entitled to  
16 deduct the amount at issue under either section 162 or section 165.

17 Attachments: Exhibits A and B

18 ///

19 Maleksalehi2\_cdd  
20  
21

22 <sup>4</sup> Exhibits may be sent to:

Mira Tonis  
Board Proceedings Division  
State Board of Equalization  
P. O. Box 942879 MIC: 80  
Sacramento, CA 94279-0081

25 <sup>5</sup> The specified statutes concern robbery (Penal Code section 211 et seq.); pimping (Penal Code section 266h); pandering  
26 (Penal Code section 266i); obscene matter (Penal Code section 311 et seq.); indecent exposure, obscene exhibitions, and  
27 disorderly houses (Penal Code section 314 et seq.); burglary (Penal Code section 459 et seq.); theft and related crimes (Penal  
28 Code section 484 et seq.); embezzlement (Penal Code section 503); and offenses involving controlled substances (Health and  
Safety Code section 11350 et seq.). IRC section 280E provides that no deduction or credit shall be allowed for any amount  
paid or incurred during the taxable year in connection with the illegal sale of drugs. Appellant pled guilty to the federal  
crimes of mail fraud, money laundering, conspiracy to commit crimes against the United States, and making a false  
statement.

Appeal of Nemat Maleksalehi and  
Maryam Maleksalehi

**NOT TO BE CITED AS PRECEDENT** - Document prepared for Board  
review. It does not represent the Board’s decision or opinion.

1 Charles D. Daly  
Tax Counsel  
2 Board of Equalization, Appeals Division  
450 N Street, MIC:85  
3 PO Box 942879  
Sacramento CA 95814  
4 Tel: (916) 322-5891  
Fax: (916) 324-2618  
5

6 Attorney for the Appeals Division

7 **BOARD OF EQUALIZATION**  
8 **STATE OF CALIFORNIA**  
9

10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **PERSONAL INCOME TAX APPEAL**  
12 **NEMAT MALEKSALEHI AND** ) Case No. 395817  
13 **MARYAM MALEKSALEHI<sup>1</sup>** )  
14 \_\_\_\_\_ )

	<u>Year</u>	<u>Claim For Refund</u>
	2001	\$115,870

18 Representing the Parties:

19 For Appellants: Jerome A. Bellotti  
20 For Franchise Tax Board: Raul A. Escatel, Tax Counsel  
21

22 QUESTION: Whether appellants have shown that they are entitled to deduct certain  
23 expenses that they paid in connection with a plea bargain with the federal  
24 government.  
25  
26

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28 <sup>1</sup> Appellants reside in Santa Clara County.

1 HEARING SUMMARY2 Background

3 Appellant<sup>2</sup> was an owner of residential rental real property in California and other states.  
4 After investigations by the United States Attorney's Office and the District Attorney's Office of Santa  
5 Clara County, they concluded that appellant had developed a fraudulent plan to obtain funds from the  
6 United States Department of Housing and Urban Development ("HUD") by submitting such documents  
7 to HUD as false expense reports, false tenant records, and invoices for work that was never done to his  
8 properties. As a result of their investigations, they obtained indictments against him. Allegedly on July  
9 10, 2001, appellant entered into a federal plea agreement ("Plea Agreement") under which he pled guilty  
10 to mail fraud under 18 United States Code (U.S.C.) section 1341, money laundering under 18 U.S.C.  
11 section 1956(a)(1)(B)(i), conspiracy under 18 U.S.C. section 371, and making false statements under 18  
12 U.S.C. sections 1001 and 1002. (See the unexecuted Plea Agreement attached to the appeal letter.)  
13 Under the Plea Agreement, appellant apparently agreed to "18 months imprisonment, 3 years of  
14 supervised release (with conditions to be fixed by the Court), no fine, and a \$400 special assessment,  
15 which [he] agree[d] to pay prior to [his] plea of guilty...[and] to pay a total of \$1,406,255 in  
16 restitution.." (App. Ltr., Plea Agreement at p. 7.) Appellant allegedly also entered into a settlement  
17 agreement ("Settlement Agreement") with HUD under which, in pertinent part, he agreed to divest  
18 himself of properties insured by HUD and to be barred permanently from participating in certain  
19 transactions with the federal government. (See page seven, paragraphs two and three of the unexecuted  
20 Settlement Agreement that is attached to the appeal letter.) It is apparently undisputed that appellant  
21 paid the amount of \$1,406,255 to the federal government in 2001.

22 On an amended joint California resident tax return for 2001, appellants took the position  
23 that they were entitled to a deduction of the payment of \$1,406,255 under Internal Revenue Code (IRC)  
24 section 165 on the basis that the payment was not a penalty whose deduction was prohibited by IRC  
25 section 162(f). After respondent denied their resulting claim for refund of \$115,870, this timely appeal  
26 followed.

27 \_\_\_\_\_  
28 <sup>2</sup> For ease of reference, this hearing summary will generally refer to appellant-husband as "appellant" and will sometimes  
refer to appellants as "appellant." Appellant-wife is a party to the instant appeal only because she signed the appeal letter.

1           Contentions

2           Appellant contends that he is entitled to deduct the amount of \$1,406,255 because that  
3 amount allegedly represents “ordinary and necessary” business expenses under IRC section 162(a). In  
4 particular, appellant takes the position that the amount represented “necessary” business expenses  
5 because the payment of that amount allegedly allowed him to continue to do business with HUD.  
6 However, appellant provides no documentary evidence in support of that position. Appellant cites  
7 Treasury Regulation section 1.162-21(c), Example (1), and *Talley Industries, Inc. v. Commissioner*  
8 (1994) T.C. Memo 1994-608 (*Talley Industries I*), to support his position that the amount at issue that he  
9 paid was restitution rather than a fine or similar penalty and, therefore, its deduction was not precluded  
10 under IRC section 162(f). Finally, although appellant does not directly discuss IRC section 165 in his  
11 briefing, he denies that the “public policy” discussion in *Richey v. Commissioner* (1959) 33 T.C. 272,  
12 regarding section 165, applies to the instant matter.

13           Respondent contends that appellant is not entitled to deduct the amount at issue.  
14 Respondent’s primary argument in support of its contention is that the claim of right doctrine precludes  
15 the deduction because appellant’s fraudulent activities never entitled him to the amount at issue.  
16 Respondent’s alternative argument is that R&TC section 17282 by its terms precludes the deduction.  
17 Respondent does not in its briefing address directly the issues that appellant raised under IRC section  
18 162 and, in particular, does not discuss the relationship between R&TC section 17282 and IRC section  
19 162(f).

20           Law

21           IRC section 162(a) provides, in pertinent part, that there shall be allowed a deduction for  
22 all the ordinary and necessary expenses incurred during the taxable year in carrying on any trade or  
23 business. IRC section 162(f) provides that no deduction shall be allowed under section 162(a) for any  
24 fine or similar penalty paid to a government for the violation of any law. R&TC section 17282 provides,  
25 in pertinent part, that no deduction shall be allowed to any taxpayer on any of his gross income directly  
26 derived from illegal activities, as defined in various provisions of California Codes, or from his gross  
27 income derived from any other activities that directly tend to promote or to further, or are directly  
28 connected or associated with, those illegal activities.

1 IRC section 165(a) states that a deduction shall be allowed for any loss sustained during  
2 the taxable year that is not compensated for by insurance or otherwise.

3 STAFF COMMENTS

4 As noted above, neither party has discussed the relationship between R&TC section  
5 172782 and IRC section 162(f), in particular whether section 17282 is patterned after section 162(f) or is  
6 more restrictive than the latter section. That relationship is apparently an issue of first impression before  
7 the Board, and the parties should be prepared to discuss that relationship in detail at the hearing.

8 Staff notes that *Talley Industries I* was reversed and remanded with regard to part of the  
9 amount at issue there by *Talley Industries, Inc. v. Commissioner* (9<sup>th</sup> Cir. 1997) 116 F.3d 382 (*Talley*  
10 *Industries II*), in which the Ninth Circuit clarified the standards under which the matter was to be  
11 considered on remand. In *Talley Industries, Inc. v. Commissioner* (1999) T.C. Memo 1999-200, *affd.*  
12 (9<sup>th</sup> Cir. 2001) U.S. App. LEXIS 20709, the tax court concluded that the taxpayer had not satisfied its  
13 burden of proof under those standards. Staff notes further that there is apparently a division of authority  
14 in the federal courts whether the standards under *Talley Industries II* are applicable with regard to IRC  
15 section 162(f). The parties should be prepared to comment at the hearing on the applicability of those  
16 standards. With regard to those standards, the parties should be prepared to provide evidence and legal  
17 argument regarding the degree to which the federal statutes to which appellant pled guilty were punitive  
18 or compensatory in nature and documentary or testamentary evidence regarding how the parties to the  
19 Plea Agreement viewed the nature of the payment at issue under that agreement.

20 Finally, the parties should be prepared to discuss at the hearing whether appellant  
21 experienced a "loss" for purposes of IRC section 165 and, if so, whether the limitations under IRC  
22 section 162(f), apply to section 165.

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25 ///

26 Maleksalehi\_cd



STATE BOARD OF EQUALIZATION  
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Fourth District, Los Angeles

JOHN CHIANG  
State Controller

RAMON J. HIRSIG  
Executive Director

January 18, 2008

Jerome A. Bellotti  
Jerome A. Bellotti & Associates

State of California  
Franchise Tax Board  
Raul A. Escatel, Tax Counsel  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720

Appeal of Nemat Maleksalehi and Maryam Maleksalehi  
Case ID No. 395817

Dear Mr. Bellotti and Mr. Escatel:

Pursuant to the Board's order of December 11, 2007, the parties in the instant matter should provided additional briefing and information as follows:

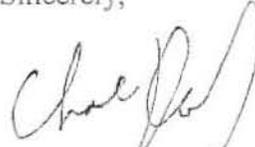
- (1) Appellants should provide an executed and dated copy of the Plea Agreement attached to their appeal letter. Staff notes that the 3<sup>rd</sup> Amended Judgment in appellant-husband's federal criminal case, presented as Exhibit B4 at his hearing before the Board, related only to his guilty pleas with regard to mail fraud and money laundering and did not provide for any amount of restitution even though the Plea Agreement provided for restitution of \$1,406,255. Appellants should verify that their Exhibit B4 is the final amended judgment relating to their federal guilty pleas for mail fraud and money laundering and provide any similar final judgments relating to their guilty pleas for conspiracy and making false statements. Appellants should also provide any "presentence report" or similar document mentioned in 18 U.S.C. section 3664(a) with respect to those final judgments and any narrative report explaining why a deduction of \$1,406,255 was allowed in the IRS "Examination Changes" that was part of their Exhibit B4. In addition, appellants should provide any other documents accounting for the

- restitution of the amount of \$1,406,255. Finally, appellants should provide arguments, with appropriate citation to authority, whether the restitution stated in a particular document is compensatory or punitive for purpose of IRC section 162(f).
- (2) Appellants should discuss the distinction, for purposes of IRC section 162(f), between civil penalties that are intended to punish violations of the law and civil penalties that are intended to encourage prompt compliance with the law or to compensate another party for expenses incurred as a result of the violation that was drawn in *Huff v. Commissioner* (1983) 800 T.C. 804, 824 (citing *Southern Pacific Transportation Co. v. Commissioner* (1980 T.C. 497, 652). Appellants should provide evidence regarding whether the federal criminal statutes to which appellant-husband pled guilty were intended to punish violations of those statutes or to compensate the victims of those violations. In particular, appellants should provide documentary evidence showing whether the restitution amounts at issue were compensatory payments to the Department of Housing and Urban Development. In addition, to take into account possible situations in which a statute has multiple purposes (as discussed in *S&B Restaurant, Inc. v. Commissioner* (1980) 73 T.C. 1226, 1232), appellants should provide affidavits from the persons who negotiated the Plea Agreement regarding whether the parties to that agreement intended the restitution payments to be punitive or compensatory. Appellants should also discuss whether *Waldman v. Commissioner* (1987) 88 T.C. 1384, applied a more restrictive test than the test announced in *Southern Pacific Transportation Co.* and *Huff* and, if so, which is the more appropriate test to be applied here. In that regard, appellants should discuss the relationship of the *Waldman* case to the *Talley* cases, which culminated in *Talley Industries, Inc. v. Commissioner* (2001) U.S. App. LEXIS 20709. Finally, appellants should discuss whether there are "public policy" considerations applicable to IRC section 165, and independent of the restrictions stated in IRC section 162(f), that would defeat the deduction of the restitution payment.
  - (3) Appellants should discuss whether IRC section 162(f) or Revenue and Taxation Code (R&TC) section 17282 applies here. In particular, appellants should discuss whether the application of R&TC section 17282 is limited to situations in which the California statutes mentioned in section 17282 are violated and, if so, whether there is any reason to conclude that section 17282 is applicable to the instant matter. Appellants should also discuss whether the test for deductibility under R&TC section 17282 is more restrictive than the test under IRC section 162(f) announced in *Southern Pacific Transportation Co.* and *Huff* or as restrictive as the test seemingly applied in *Colt Industries, Inc. v. United States* (1989) 880 F.2d 1311.
  - (4) Appellants should discuss whether an "adjustment to income," as contrasted with a deduction, is possible with regard to the restitution amount at issue here for years earlier than 2001. Appellants should identify with great specificity the legal basis under which such an "adjustment to income" might occur. Appellants should also state whether the statute of limitations might apply to preclude any "adjustment to income" for those years and, if so, identify any arguments that might defeat the application of the statute of limitations.

Appellants should provide the foregoing briefing and information, with a copy to respondent, to the Board Proceedings Division (BPD) within 30 days of the date of this letter. Respondent shall have 30 days from the date of the receipt of its copy to file its reply with BPD, with a copy of its

reply to appellants. Appellants shall then have 30 days from its receipt of respondent's reply to file a copy of its response with BPD, with a copy to respondent. The parties should feel free to consult with each other, and with me, regarding any issue raised by this letter. I may be reached by telephone at (916) 322-5891.

Sincerely,



Charles D. Daly  
Tax Counsel III

CDD:bb

cc: Franchise Tax Board – Legal (MS- A260)

Nemat Maleksalehi  
Maryam Maleksalehi

[REDACTED]