BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JOHN AND CODELLE PEREZ)

For Appellants: John R. Hopson
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Robert S. Shelburne and
John D. Schell
Counsel

O P I N I O N

This appeal is made pursuant to sections 18646 and 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of John and Codelle Perez for reassessment of a jeopardy assessment of personal income tax in the amount of $2,100.00 for the period January 1 through November 15, 1967.

On November 14 1967, John Perez (hereafter referred to as appellant) was arrested and charged with the illegal possession and sale of narcotics. He eventually pled guilty to violation of section 11531 of the California Health and Safety Code, which prohibits the sale of marijuana, and he was thereafter sentenced to state prison. On November 15, 1967, upon notification of appellant's arrest, respondent Franchise Tax Board issued a jeopardy assessment against appellant in the amount of $2,100.00 for the period beginning January 1, 1967, and ending November 15, 1967. The propriety of that assessment is the sole issue raised by this appeal.

The following chain of events led up to appellant's arrest and the jeopardy assessment against him:

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1. In 1967 the California Bureau of Narcotic Enforcement (hereafter referred to as the Bureau) was notified by an informer that appellant was selling marijuana and heroin. In order to obtain evidence of appellant's illegal sales activity the Bureau arranged for several of its agents to pose as buyers.

2. On September 27, 1967, agent Miller was introduced to appellant and purchased 21.5 grams of heroin for $200.

3. On September 29, 1967, agents Miller and Thompson met appellant and purchased 5 kilo bricks (4,528 grams) of marijuana for $350. During that transaction appellant stated to the agents that he had already sold 100 kilo bricks of marijuana that week and could obtain more. He aiso offered to sell jars of amphetamine tablets at $30 per jar, but the agents rejected that offer.

4. On October 6, 1967, agent Miller contacted appellant and purchased 3 kilo bricks (2,631.9 grams) of marijuana for $195. An arrangement was made to purchase 10 kilo bricks in the near future.

5. Agent Thompson telephoned appellant on October 25, 1967. Appellant stated he would not be able to deliver any marijuana for a few days because a shipment of 200 kilo bricks which he was expecting had been seized at the Mexican border. He offered instead to sell heroin at $200 an ounce, or amphetamine tablets at $30 per jar or $1300 per 50 jar lot. Later that same day agent Thompson met appellant and purchased 29.0 grams of heroin for $200.

6. On November 14, 1967, agent Thompson telephoned appellant and arranged to buy 4 ounces of heroin at $195 per ounce, 60 kilo bricks of marijuana at $55 per kilo, and 10 jars of amphetamine tablets at $28 per jar, for a total price of $4,360. When agent Thompson arrived at the agreed meeting place, appellant told him that he only had 57 kilo bricks of marijuana, and the total price was therefore adjusted to $4,195. Appellant indicated several boxes in his car

which he stated contained the narcotics. At this point agent Thompson alerted other surveillant agents and appellant was placed under arrest . Bureau agents searched him and removed $64 in cash from his wallet. A search of appellant's car disclosed 58 kilo bricks of marijuana, 10 jars of amphetamine tablets, and 116.9 grams (4.1 ounces) of heroin.

The Bureau agents then proceeded to appellant's residence. There they found approximately 9 ounces of marijuana, some amphetamine tablets, and small amounts of heroin and cocaine. Under the mattress in appellant's bedroom agents found $1,900 in United States currency, which they confiscated.

Respondent was notified of appellant's arrest and the circumstances surrounding it on November 15, 1967. The instant jeopardy assessment in the amount of $2,100 was issued on that same day, upon determination by respondent that the evidence of appellant's illegal sales of narcotics and the unreported income resulting therefrom justified such an assessment.

In the absence of any records, respondent was obliged to estimate appellant's income from sales of drugs during 1967. That estimate was based upon projections of appellant's known and potential receipts of cash while he was under surveillance, and on the oral statement made by appellant to Bureau agents on September 29, 1967, that he had already sold 100 kilo bricks of marijuana that week. (Appellant was charging about $70 per kilo brick of marijuana.) Respondent ' s alternative calculations were as follows:

1. Over the 49-day period from appellant's initial contact with Bureau agents until his arrest, sales or attempted sales occurred on 5 separate days. Totalling these sales and potential sales and dividing the sum by 5, appellant's average sales per day to Bureau agents amounted to $1,028. Respondent assumed that on the other 44 days of the 49-day period appellant was making sales to others. Respondent further assumed, in the absence of any records, that the sales to Bureau agents were representative of appellant's sales to other customers. Under this method of computation, unreported sales by appellant for the 49-day period would total $50,372 ($1,028 x 49).

2. During the same 49-day period, 4 sales and 1 attempted sale were in evidence. At that rate of sales per 49-day period, there would be 32.5 sales in the whole short-term taxable period (January 1, 1967, to November 15, 1967). Using the same average income per sale figure, unreported sales by appellant would total $33,410 ($1,028 x 32.5).

Either one of the above estimates of appellant's unreported income in 1967 would have resulted in a greater tax liability than the amount of the jeopardy assessment issued against appellant. However, respondent determined that under the circumstances it would be futile to assess taxes in excess of the amount of money confiscated from appellant's person and residence, at the time of his arrest. Respondent therefore reduced the net income figure to $28,450 which, allowing for a personal exemption, produced a tax of $2,100.

The $1,964 taken from appellant's person and residence at the time of his arrest was obtained by respondent from the Bureau of Narcotic Enforcement pursuant to section 18807 of the Revenue and Taxation Code. That section provides, in pertinent part:

> The Franchise Tax Board may ... require any ... department of the State,... having in . . . [its] possession, or under ... [its] control, any . . . personal property or other things of value, belonging to a taxpayer . . . to withhold, from such . . . personal property or other things of value, the amount of any tax, ... due from a taxpayer under this part and to transmit the amount withheld to the Franchise Tax Board at such times as it may designate.

On November 24, 1967, appellant filed a petition for reassessment of the jeopardy assessment, in accordance with section 18643 of the Revenue and Taxation Code. At appellant's request (Rev. & Tax. Code, §18645), a conference with respondent's auditor was held.

On February 13, 1968, respondent received a joint personal income tax return filed by appellant and his wife for 1967. That return showed an adjusted gross income of $7,337.80 for 1967, derived from various employments of appellant and his wife. No income from sales of

narcotics was reported.. After consideration of all the evidence in the case, respondent concluded that its reconstruction of appellant's income was reasonable and that appellant had failed to provide information from which a more accurate statement of income, including income from his sales of narcotics, could be prepared. Respondent's denial of appellant's petition for reassessment gave rise to this appeal.

The substance of appellant's argument is that respondent has arbitrarily estimated appellant's income for 1967 as a basis for the jeopardy assessment here in issue. Appellant urges that there is no evidence that he ever sold more than $945 worth of narcotics during 1967, that being the total amount of the completed sales to narcotics agents which were mentioned earlier. Appellant's representative discounts the statement made by appellant on September 29, 1967, to narcotics agents, viz, that he had already sold 100 kilo bricks of marijuana that week, as the "puffing" of a small scale dealer in narcotics.

As a preliminary matter, it is well established under comparable federal law that the taxing authority's decision to issue a jeopardy assessment is not subject to review but is a matter left within the broad discretion of that authority. (Transport Mfg. & Equip. Co. of Delaware v. Trainor, 382 F.2d 793; Brown-Wheeler Co., 21 B.T.A. 755; California Associated Raisin Co., 1 B.T.A. 1251.) This leaves for our consideration only the question of the propriety of the deficiency determined by respondent.

Under the California Personal Income Tax Law, a husband and wife electing to file a joint return are required to state specifically the items of their combined gross income during the taxable year. (Rev. & Tax. Code, §§18401,18402.) As in the federal income tax law, gross income is defined to include "all income from whatever source derived," unless otherwise provided in the law. (Rev. & Tax. Code, § 17071; Int. Rev. Code of 1954, § 61.) The United States Supreme Court has held that "gross income" includes gains derived from illegal activities, requiring the filing of a return reporting such gains. (United States v. Sullivan, 274 U.S. 259 [71 L. Ed. 1037].) On the basis of that decision, it has specifically been held that gain from the illegal sale of narcotics is taxable income. (Farina v. McMahon, 2 Am. Fed. Tax R.2d 5918.)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4); Treas. Reg. § 1.446-1(a)(4).) In the absence of

such records, the taxing authority is authorized to compute income by whatever method will, in its opinion, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b); Int. Rev. Code of 1954, § 446(b); Breland v. United States; 323 F.2d 492; Harold E. Harbin, 40 T.C. 373.) The taxing authority's determination of a deficiency is presumptively correct, and the burden is on the taxpayer to prove that the correct income was an amount less than that on which the deficiency assessment was based. (Kenney v. Commissioner, 111 F.2d 374.)

No particular method of reconstructing income is required of the taxing authority, as the circumstances will vary in individual cases. Harold E. Harbin, supra. The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States, 226 F.2d 331.) In the absence of accounting records, the Commissioner of Internal Revenue has reconstructed the income of a motel on the basis of the number of fresh sheets rented by the motel during the taxable year (Agnellino v. Commissioner, 302 F.2d 797), and has estimated a waitress' income from tips on the basis of total food sales of the'restaurant, (Dorothy L. Sutherland, 32 T.C. 862.)

Appellant raises several objections to the method of income projection used by respondent in arriving at an estimated income figure. First, appellant seems to disapprove of the use of a period of only 49 days as a basis for estimating an entire year's income. However, appellant has failed to offer any evidence by which a more accurate estimate could be.made. Furthermore, the Internal Revenue Service has been upheld in its reconstruction of a gambler's income for one year on the basis of adding machine tapes for only four days of betting operations, where that was the only information available. (Isaac T. Mitchell, T.C. Memo., June 27, 1968, aff'd, 416 F.2d 101.) Under the circumstances, we cannot say that the 49-day time factor used by respondent was unreasonable.

Secondly, appellant questions the propriety of including in any income estimate the values involved ($4,195) in the sale of drugs which was to take place on November 14, 1967, but which was never concluded because of appellant 's arrest. It is true that the sale was never consummated; however, the appellant did have the agreed quantities of narcotics in his possession, was capable of completing the sale and, but for his arrest, probably would have completed the transaction. We do not believe that respondent has acted unreasonably in considering the potential income from that transaction in making its income projections.

Appellant also contends that respondent has improperly failed to make any allowance for the cost to appellant of the narcotics which he sold, but has instead treated his gross income from such sales as if it were net income. Appellant has offered no evidence as to the amount of such cost or basis in his own case. Furthermore, even if he had submitted such proof, it does not appear that any deduction of costs would be in order. The federal law is clear that the deduction of expenses incurred in an illegal business may be disallowed, if the payments for which the deduction is claimed were in violation of public policy, (Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 [2 L. Ed.2d 562].) This rule has been applied to deny a deduction for the cost of purchasing liquor in states where its possession was prohibited. (Finley v. Commissioner, 255 F.2d 128; Lorraine Corp., 33 B.T.A. 1158.) We believe that a similar conclusion would be reached with respect to illegal sales of narcotics.

Upon review of the entire record we find no basis for overturning the action taken by respondent.

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,

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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 John and Codelle Perez for reassessment of a jeopardy assessment of personal income tax in the amount of $2,100.00 for the period January 1 through November 15, 1967, be and the same is hereby sustained.

Done at Sacramento, California, this 16th day of February, 1971, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary