

Appeal of James Eugene Ely

The issues are whether appellant received unreported income from illegal sales of narcotics and, if he did, whether respondent properly reconstructed the amount of that income.

On March 28, 1976, appellant James Eugene Ely was placed under arrest by Contra Costa County police officers.. A search of appellant's automobile produced \$32,000 in cash and several plastic packets containing what appeared to be heroin.- Appellant was charged with possession of illegal substances. After being informed of appellant's arrest, respondent Franchise Tax Board terminated appellant's 1976 taxable year and issued a jeopardy assessment in the amount of \$11,239 for the period January 1 through March 28, 1976. Respondent also issued an order to withhold \$11,239 of the \$32,000 noted above. Thereafter, respondent reduced the jeopardy assessment to \$7,155.

Subsequent to appellant's arrest, respondent obtained an apparent "drug sales record" allegedly kept by appellant for the period February 23 to March 26, 1976. This journal was on appellant's person when he was arrested. On the basis of the entries in the journal, respondent determined that appellant sold \$71,645 worth of heroin during the period for which the journal was kept. From data received from the Bureau of Narcotics Enforcement, respondent determined that such heroin had cost appellant approximately \$28,658. Thus, respondent attributed \$42,987 of unreported income to appellant for the period February 23 to March 28, 1976. Respondent also attributed \$30,240 of unreported income to appellant for the period January 1 to February 22, 1976.

Respondent notes that appellant was arrested twice in 1975 for drug related offenses. In May of 1975 appellant was arrested in possession of two bindles of cocaine, one ounce of heroin and approximately \$1,500 in cash. In October of 1975 he was arrested in possession of eight ounces of heroin. Respondent also notes that the journal pages appear to be continuations from other pages. Respondent concluded, therefore, that appellant had been engaged in the sale of illegal substances at least since May of 1975, and used this as the basis for attributing unreported income to appellant for the January 1 to February 22, 1976, period.

Appellant disagreed with the above determinations and petitioned for reassessment. After due consideration, respondent affirmed the jeopardy assessment, and appellant appealed.

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Both the federal and state income tax regulations require each taxpayer to maintain such accounting records as will enable him to file a correct return. (Treas. Reg. § 1.446-1(a)(4); Cal. Admin. Code, tit. 18, req. 17561, subd. (a)(4).) If the taxpayer does not maintain such records, the taxing agency is authorized to compute his income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code § 17561, subd. (b).) 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 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16 1971) Mathematical exactness is not required. (Hal-oid E: Harbin, 40 T.C. 373. 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.) The presumption is rebutted, however, where the reconstruction is shown to be arbitrary and excessive or based on assumptions which are not supported by the evidence. (Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964) affd. sub nom. Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966).)

Basically, appellant challenges the assessment as being arbitrary and excessive. He denies that the mentioned journal is a record of drug sales, and therefore asserts that the evidence does not support the contention that he earned \$101,885 during the assessment period. For the reasons stated below, we find appellant's position untenable.

In spite of appellant's denial, we believe that the journal reasonably represents a journal of drug sales. The circumstances of appellant's March 1976 arrest provide a basis for concluding that appellant was engaged in the sale of drugs. It was therefore reasonable for respondent to conclude that the notations in the journal referred to drug sales.

Respondent's conclusion that appellant's two arrests in 1975 were evidence that appellant was engaged in the sale of drugs at least back to January 1, 1976 was also reasonable. Appellant has argued the opposite, citing Pizzarello v. United States, 408 F.2d 579 (2d Cir.), cert. den., 396 U.S. 986 [24 L. Ed. 2d 450] (1969) and Appeal of Burr McFarland Lyons, Cal. St. fld.

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of Equal., Dec. 15, 1976. However, we believe appellant's reliance on those cases is misplaced.

In Pizzarello, supra, it was held that past gambling activity could not be assumed in the absence of any evidence in that regard, and in Lyons, supra, we held that the Franchise Tax Board could not assume the taxpayer's involvement in drug sales activity solely on the basis of his having had a gun permit. In the instant case, however, we have evidence of past activity which is directly related to activity forming the subject of the assessment. Where there is an independent evidentiary basis for determining that the taxpayer was involved in the subject activity during the period covered by the assessment, the reconstruction of income has been upheld. (Pinder v. United States, 330 F.2d 119 (5th Cir. 1964); Mersel v. United States, 420 F.2d 517 (5th Cir. 1970); United States v. Janis, 428 U.S. 433, 437 [49 L. Ed.2d 1046] (1976); Hamilton v. United States, 309 F. Supp. 468, 472-473 (S.D. N.Y. 1969), affd., 429 F.2d 427 (2nd Cir. 1970) cert. den., 401 U.S. 913 [27 L. Ed. 2d 812] (1971); Sciannameo v. Dath, 373 F. Supp. 1120 (E.D. N.Y. 1974).) The use of related prior arrests, in particular, to establish the base for the assessment period was approved in Sciannameo.

As concerns the amount of the assessment, it appears that respondent has also been reasonable. The level of drug sales activity attributed to appellant for the February 23 to March 26 period was determined directly from data in the journal. This data allowed respondent to determine that appellant's sales were about 16 ounces per week during that period. Using this determination as a starting point, respondent chose to be conservative and to assume that appellant's sales during the January 1 to February 22 period averaged seven ounces per week. Given the 16 ounce average -calculated from the journal data, the seven ounce figure appears to be well within reason. (Hamilton v. United States, supra; Sciannameo v. Dath, supra; Pinder v. United States, supra.) The combined assessment, therefore, appears to be appropriate under the circumstances.

Appellant makes several other assertions in an attempt to undermine respondent's reconstruction of income for the period in question. We do not find them persuasive. Again, we emphasize the fact that when the taxpayer fails to comply with the law in supplying the required information to accurately compute income and respondent finds it necessary to reconstruct the

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taxpayer's income, some reasonable basis must be used. Respondent must resort to various sources of information to determine such income and the resulting tax liability. In such circumstances, the reasonable reconstruction of income will be presumed correct, and the taxpayer has the burden of disproving such computation even though crude. (Agnellino v. Commissioner, 302 F.2d 797 (3d Cir. 1962); Merritt v. Commissioner, 301 F.2d 484 (5th Cir. 1962).) **Mere** assertions by the taxpayer are not enough to overcome that presumption. (Pinder v. United States, supra.)


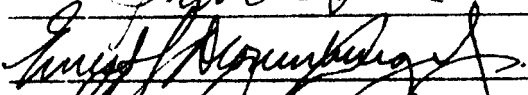


After reviewing the entire record, we find no basis for reversing the action taken by respondent.

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,

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 James Eugene Ely for redetermination of a jeopardy assessment of personal income tax in the amount of \$7,155.00 for the period January 1, 1976, through March 28, 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of September, 1980, by the State Board of Equalization.


_____, Chairman

_____, Member

_____, Member

_____, Member
_____, Member