BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
EDUARDO L. AND LETICIA RAYGOZA)

For Appellants: Allan P. Donnelly
Attorney at Law

For Respondent: James C. Stewart
Counsel

OPINION

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Eduardo L. and Leticia Raygoza for reassessment of a jeopardy assessment of personal income tax in the amount of $12,427.73 for the year 1976.

The principle issue presented for our determination is whether respondent properly reconstructed the amount of income earned by Eduardo L. and Leticia Raygoza (hereinafter referred to as "appellant-husband" and "appellant-wife," respectively, and collectively referred to as "appellants") from illegal sales of narcotics during the appeal period. In order to properly consider this issue, the relevant facts concerning appellants' arrest and the subject jeopardy assessment are set forth below.,

On or about April 1, 1976, Los Angeles area law enforcement authorities met with a confidential reliable informant ("CRI") who told them that appellant-husband had been trafficking in heroin and cocaine for some time. The reliability of the CRI was established by the Los Angeles Police Department and the Drug Enforcement Administration ("DEA"). Both agencies confirmed that the CRI had previously supplied accurate information concerning narcotics operations and that such information had resulted in arrests, convictions, and the seizure of narcotics.

Following the April meeting with the CRI, police surveillance of appellant-husband was initiated: this surveillance continued on an intermittent basis until July 8, 1976, the day of appellants' arrest on charges of conspiracy to sell heroin and possession for sale of cocaine and heroin. During the course of this surveillance, law enforcement authorities noticed the emergence of a pattern in appellant-husband's daily activities. Investigators observed that he would commence by driving from either his residence or that of one Maria Raygoza, proceed to a public telephone booth, make several telephone calls, proceed to another telephone booth, and then drive to an apartment leased by one Ramon Gomez. After approximately five to ten minutes, appellant-husband would leave the Gomez residence and drive to various locations in Los Angeles County where he would conclude what appeared to be a number of drug sales.

In addition to apparent drug sales transacted at various locations in Los Angeles County, police. investigators noted that pedestrian traffic to and from appellants' residence or that of Maria Raygoza would invariably increase when appellant-husband was at either of those locations. Individuals seen entering those residences stayed no longer than ten minutes before leaving. The description of the surveillance

activities reveals that appellant-husband's activities over the course of the approximate three-month surveillance period remained rather consistent and that there was neither a noticeable increase or decrease in the number of apparent drug-related transactions completed from day to day.

As part of their investigation into appellants' trafficking of narcotics, investigators agreed to conduct a surveillance of the CRI making a purchase of heroin from appellant-husband, Following his above described routine, appellant-husband met with the CRI during the course of his "rounds" and the sale was transacted at a location in Los Angeles County. A subsequent drug identification test revealed that the substance sold to the CRI was heroin. Apparently for the purpose of protecting the CRI's identity, law enforcement authorities have not disclosed details as to the date or location of the sale, or as to the quantity, price, or purity of the heroin sold.

In the latter part of May 1976, the CRI notified police authorities that appellant-husband was planning to suspend his operations for two or three weeks because of what appeared to him to be police surveillance of his activities. At virtually the same time, local law enforcement authorities became aware of an overlapping DEA investigation of a major narcotics organization possibly involving appellant-husband. In order to allow the federal investigation to continue without interference, the local authorities suspended their surveillance activities until the last week of June. The CRI subsequently informed police officials that appellant-husband had returned to selling narcotics during the second week of June.

Late in the evening of July 8, 1976, appellants were arrested at their residence and charged with conspiracy to sell heroin; appellant-husband was also charged with possession for sale of heroin and cocaine. At the time of her arrest, appellant-wife was apprehended with three clear plastic bags containing a total of 81 grams (approximately 2.835 ounces) of heroin. Simultaneously with appellants' arrest, Mr. Gomez was arrested in his apartment by officers of the Inglewood Police Department ("IPD"). When informed of appellants' arrest, Mr. Gomez told the arresting officers that appellant-husband had left a suitcase in his apartment five days earlier. Upon opening the suitcase, the officers discovered 37 packages of various sizes containing

heroin weighing a total of 4,436 grams (approximately 9.9 pounds), 17 clear plastic bags containing cocaine weighing 486.5 grams (approximate y 1.1 pounds), and additional materials used to adulterate and package heroin and cocaine.

Respondent issued each appellant a separate jeopardy assessment soon after their arrest. In issuing the jeopardy assessments, respondent found it necessary to estimate appellants' income for the appeal period. Utilizing the then-available evidence, respondent determined that appellants' total taxable income from drug sales in 1976 was $120,000.

On August 16, 1976, appellants filed a petition. for reassessment of the jeopardy assessments: they also requested that proceedings on their petition be deferred pending the outcome of the criminal proceedings pending against them. Pursuant to respondent's request, appellants subsequently furnished a financial statement for 1974, 1975, and 1976 in which they indicated no income from the sale of narcotics. In a letter to respondent dated October 13, 1977, however, appellants' attorney asserted that his clients' income from drug sales in 1976 totaled $3,150. He subsequently explained that, for a total of four and one-half months prior to their arrest, appellants sold five ounces of heroin per month for $500 an ounce; their profit per ounce was purportedly $150.

Based upon new information obtained from the successful criminal prosecution of appellants, as well as data obtained from the Bureau of Narcotic Enforcement ("BNE"), respondent devised two alternative methods of reconstructing appellants' income from narcotics sales. Those computations are as follows: (i) respondent rejected appellants' contention that they had been dealing in narcotics for four and one-half months and, instead, relied upon an IPD estimate that they were engaged in drug trafficking since the beginning of 1976. Based on the trial testimony of Mr. Gomez, respondent deduced that appellants had been selling 50 ounces of heroin each month. Finally, relying upon data provided by the BNE, respondent determined that appellants had been purchasing their heroin at $500 an ounce and selling it at a 100 percent profit. Under this method of computation, appellants' drug-related income in 1976 would total $150,000; (ii) respondent accepted appellants' assertion that they were making a net profit of $150 an ounce. However, it relied upon BNE experience

that narcotics dealers typically turn over their inventory once a month in determining that appellants had been selling 160 ounces of heroin per month (at the time of their arrest, a total of more than 10 pounds of heroin was seized). Using the same six-month projection period utilized in its first alternative reconstruction, this computation would result in unreported income from drug sales totaling $144,000.

Appellants filed a joint return for 1976 in which they claimed an adjusted gross income of $12,963. Respondent then issued a single Notice of Action on their petitions for reassessment reflecting joint filing status and added an additional $120,000 in drug-related income to the income shown on their joint return,, thereby resulting in additional tax of $12,427.73. Respondent subsequently denied appellants' petition for reassessment of the subject jeopardy assessment.

Under the California Personal Income Tax Law, a taxpayer is required to specifically state the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) 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.) Gain from the illegal sale of narcotics constitutes gross income. (Farina v. McMahon, 2 Am. Fed.Tax.R.2d 5918 (1958).)

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

In the instant appeal, respondent used the projection method in reconstructing appellants' income from the illegal sale of narcotics. Like any method of reconstructing income, the projection method is somewhat speculative. For example, it may rest on an hypothesis that the amount of sales during a base period is representative of the level of sales activity throughout the entire projection period. (Cf. Pizzarello v. United States, 408 F.2d 579 (2d Cir. 1969), cert. den., 396 U.S. 986 [24 L.Ed.2d 4501 (1969).) The speculation is compounded when the projection method is applied to reconstruct income from suspected illegal activities. Since such activities are generally conducted covertly, there is seldom any hard evidence on which to base the reconstruction.

Given the difficulty inherent in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g.; 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); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has also been recognized, however, that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative; i.e., that he did not receive the income attributed to him. In order to assure that use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973), Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr McFarland Lyons, supra.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief'" that the amount of tax assessed against the taxpayer is due and owing. (United States v. Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr McFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

Respondent utilized information obtained from the IPD, the reports of the arresting police officers, the preliminary and trial testimony of Mr. Gomez, and data provided by the: BNE in reconstructing appellants' drug-related income. While respondent devised two alternatives to its original reconstruction of appellants' income after acquiring additional information regarding their narcotics trafficking, it is evident from its arguments on appeal that it is principally relying upon the first alternative. Specifically, respondent determined that: (i) appellants were selling SO ounces of heroin per month; (ii) their selling price was $1,000 an ounce; (iii) the average cost of "goods" sold was 50 percent of the selling price; and (iv) appellants had been in the "business" of selling heroin from the beginning of 1976.

In essence, appellants challenge the subject jeopardy assessment as being arbitrary and excessive. As set forth above, they maintain that they realized merely $3,150 in income from the sale of heroin during the period in issue. After carefully reviewing the record on appeal, we believe that appellants' assertions are untenable and that there exists ample evidence to support the reasonableness of the first three elements of respondent's projection formula.

Appellants' contention that they were selling only five ounces of heroin per month lacks credibility in view of the fact that the amount of heroin. seized at the time of appellants' arrest totaled approximately 160 ounces. Were we to accept as accurate appellants' assertion that their sales were limited to five ounces a month,. we would have to conclude that they had nearly a three-year inventory of heroin stored on the day of their arrest . In view of the fact that drug deaiers are known to turn over their inventory as often as once a month, appellants* assertion is simply not credible.'

Mr. Gomez testified at a preliminary hearing that he was paid $500 by appellants, over a one month period, for storing their heroin in his apartment.' Additionally, he testified at appellants' criminal trial that he was paid $10 for "every little bag" of heroin that they sold. On the basis of this information, respondent concluded that appellants were selling at least 50 ounces of heroin during each month that they

were trafficking in narcotics.1/ Respondent's determination that the one-month base period reflects the approximate level of sales activity over the entire projection period is not unreasonable absent any evidence to the contrary. (Appeal of David Leon Rose, supra; Hamilton v. United States, 309 F.Supp. 468 (S.D.N.Y. 1969); affd. 429 F.2d 427 (2d Cir. 1970), cert. den., 401 U.S. 913 [27 L.Ed.2d 812] (1971).) Appellants have made no effort to explain why they maintained such a massive inventory of narcotics when their sales were as minimal as they claim.

Appellants' assertion that they were seliing their heroin for only $500 an ounce is equally untenable in view of the pertinent evidence. BNE data reveals that the street price for heroin in the Los Angeles area during the years 1975-1976 ranged from a low of $500 to a high of $1,600 an ounce. The wide price differential depended, in large-part, upon the purity of the heroin being sold. Accordingly, an ounce of relatively pure heroin would sell close to the upper part of that range while severely "cut" heroin would sell close to or at the $500 an ounce figure. After obtaining additional information from the IPD, we are convinced that appellants' sales price was at least $1,000 an ounce.

During the period in which appellantswere trafficking in narcotics, the heroin being sold in the Los Angeles area generally ranged from between one and one-half to two and one-half percent purity. The heroin seized at the time of appellants' arrest, however, was found to be four percent pure. We are of the opinion, consequently, that resondent's determination that appellants sold their heroin for $1,000 an ounce is reasonable. Furthermore, given reliable information to the effect that narcotics dealers normally sell their "goods" at a 100 percent profit, it is reasonable to accept respondent's determination that appellants were purchasing their heroin for $500 an ounce.

1/ Respondent's determination that "every little bag" contained only one ounce of heroin appears to have been conservative. The police inventory of the heroin seized at the Gomez'residence indicates that 9.9 pounds of heroin was stored in 37 bags of varying size: accordingly, it is clear that the average-sized bag contained considerably more than one ounce.

Respondent's fourth and last assumption, which concerns the duration of the projection period, was apparently based upon an "est mate" by the IPD that appellants had been trafficking in narcotics since the beginning of 1976. The record, however, is devoid of any evidence to support that "estimate."

The testimony of Mr. Gomez, the CRI's disclosures to law enforcement authorities, and the police surveillance of appellant-husband all establish that appellants were involved in the sale of heroin from at least the beginning of April 1976. Additionally, the record supports a finding that they were involved in this activity for some time prior to that date. Appellants' attorney, in his above referenced October 13, 1977 letter to respondent, stated that his clients' drug-related income during the period in issue was $3,150. As noted above, he subsequently explained that this figure was arrived at by taking appellants' net profit per ounce, purportedly $150, at sales of five ounces each month. Taken at face value, this would mean that, by their own admission, appellants were involved in the heroin trade for somewhat more than four months. Later, appellants' attorney acknowledged that his clients were involved in the narcotics "trade" for four and one-half months.

While the record of this-appeal is insufficient to sustain respondent's determination that appellants were trafficking in heroin from the beginning of 1976, the pertinent evidence, as discussed above, supports the conclusion that appellants were deriving income from the sale of heroin for a total of four and one-half months prior to the time of their arrest. As modified in this respect, the subject jeopardy assessment has a foundation in fact and is not arbitrary or unreasonable.

Appellants have stated that, should respondent's action be sustained, they qualify to employ income averaging in computing the amount of income tax owed. There appears to be no controversy with regard to appellants' use of income averaging; respondent has specifically stated that, upon submission of an amended return for 1976 and other pertinent information, the use of income averaging will be reviewed.

For the above reasons, we conclude that appellants received a total of $112,500 in unreported taxable income from illegal drug sales during 1976. Respondent's jeopardy assessment shall be modified accordingly.

Appeal of Eduardo L. and Leticia Raygoza

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 Eduardo L. and Leticia Raygoza for reassessment of a jeopardy assessment of personal income tax in the amount of $12,427.73 for the year 1976, be and the same is hereby modified in accordance with this opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 29th day of July, 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman

George R. Reilly, Member

William M. Bennett, Member

Richard Nevins, Member

_____, Member