

Appeal of Philip Marshak

The principal issues presented by this appeal are the following: (i) did appellant, a cash basis taxpayer, receive unreported income from the illegal sale of narcotics during the appeal period; and (ii) did respondent properly conclude that appellant had \$239,745 in taxable income from all sources, including illegal drug sales, during the period in issue. In order to properly consider these issues, the relevant facts concerning appellant's arrest and the subject jeopardy assessment are set forth below,

On November 22, 1977, officers of the Los Angeles Police Department ("LAPD") arrested one Ronald Lee Stockert for a narcotics violation. Upon being advised of his constitutional rights, Mr. Stockert agreed to cooperate with the authorities and to provide them with information regarding his narcotics purchases. Mr. Stockert admitted that he had been purchasing heroin from appellant for two years and that his most recent purchase had taken place the day prior to his arrest. Mr. Stockert explained that he ordered heroin from appellant by telephone and was advised when to come to appellant's residence to pick up the narcotics. Stockert also stated that appellant sold other types of narcotics in addition to heroin.

On December 12, 1977, Officer Andrew J. Pedrosa of the LAPD Administrative Narcotics Buy Team, having obtained appellant's telephone number from Stockert, contacted appellant; the following telephone conversation ensued:

Appellant: "This is Phil."

Pedrosa: "I'm Andy, Ron [Stockert] gave me your number and said you could take care of me with some stuff."

Appellant: "Sure, just have Ron call me."

Pedrosa: "I'm leaving town, will you be able to take care of me."

Appellant: "Sure, I'll take care of you, just have Ron call me first."

Based on the foregoing conversation, the information acquired from Mr. Stockert, and other preliminary investigatory work, Officer Pedrosa requested, and obtained, a search warrant for appellant's residence.

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On the evening of December 15, 1977, LAPD investigators went to appellant's residence and demanded entrance for the purpose of serving the search warrant. Appellant was observed through a window by the officers but, despite repeated requests, refused to permit the officers entry. When the investigators observed that appellant was attempting to turn away from the door, they **forced** entrance into his apartment, gave him a copy of the search warrant, and commenced their search.

During the course of the search, the officers found 18.66 grams of heroin, 6.72 grams of cocaine, a small amount of marijuana, and numerous items characteristic of a drug selling operation. Additionally, a brown paper bag containing \$30,390 was found in the kitchen. Finally, **the** investigators discovered a concealed wall compartment in which appellant had secreted a number of unnegotiated checks and records of what an experienced narcotics enforcement official concluded were drug sales. Appellant claimed that the seized records represented eight months of narcotics activity with one Peter Bradley. Upon conclusion of their search, the officers arrested appellant, who identified himself as an unemployed actor/director, and charged him with possession of heroin and cocaine for sale.'

Respondent was notified of appellant's arrest on December 16, 1977. In view of the circumstances described above, and given appellant's admission that he had not filed income tax returns for approximately six years, it was determined that collection of his personal income tax liability for the period in issue would be jeopardized by delay. Accordingly, the subject jeopardy assessment was subsequently issued, terminating appellant's taxable year as of the date of his arrest. In issuing the jeopardy assessment, respondent found it necessary to estimate appellant's income for the appeal period. Utilizing the available evidence, respondent determined that appellant's total taxable income from all sources, including narcotics-related income, was \$239,745.

The evidence relied upon by respondent in reconstructing appellant's income was derived **from** the results of the police investigation and from examination of his records, including the unnegotiated checks. Respondent apparently concentrated exclusively on appellant's cocaine sales to compute his drug-related income; income from heroin sales was evidently **ignored**. Hundreds of entries were found in appellant's records

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showing apparent sales to many individuals, including Mr. **Stockert**. Some of the more revealing notations read as follows:

"10-G 1300"
"14 @ 130, 1820"
"8-G 1040"

Based upon his records and reliable data acquired from law enforcement authorities, respondent concluded that appellant had been selling cocaine for \$130 per gram. Ignoring numerous **I.O.U.s** found in the hidden **wall** compartment, and summarizing solely the confiscated checks and payments referenced in his records, respondent computed that appellant's gross income from cocaine sales during **the** appeal period totaled **\$346,265**. By dividing this amount by the aforementioned \$130 figure, respondent determined that appellant had sold at least 2,664 grams of cocaine during the period in issue. Finally, relying upon its interpretation of a notation in appellant's records, respondent concluded that appellant's cost of "goods" sold was \$40 per gram. Subtracting the cost of his cocaine from his reconstructed gross income from drug sales, respondent arrived at the previously mentioned figure of \$239,745 for appellant's taxable income.

Pursuant to section 18817 of the Revenue and Taxation Code, respondent obtained from the LAPD \$25,472 of the \$30,390 seized at the time of appellant's arrest; appellant subsequently filed a petition for reassessment. In answer to respondent's request that he furnish the information needed to accurately compute his income, including income derived from illegal drug sales, appellant filed a Statement of Financial Condition on June 15, 1978, in which he claimed that he was unemployed and had earned no income from January 1, 1975, to the date of his arrest in 1977. As part of his **petition, for** reassessment, appellant stated that he had been purchasing narcotics for one Peter Bradley and that **Bradley** provided him with a supply of narcotics for his own drug addiction. Appellant further claimed that he had never sold narcotics and that the unnegotiated checks totaling \$172,650, all drawn on Bradley's checking account, "were ... in his possession on a lark." To support this assertion, appellant obtained a declaration from Bradley, dated December 29, 1977, in which the latter stated that he and appellant frequently made wagers "over many silly, inane items." Appellant further asserted that the money seized **at** the time of his arrest

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constituted funds given him by Bradley to finance an entertainment project on which the two were supposedly collaborating; the funds had not been deposited, appellant asserted, **because** he had not obtained a "dba." Upon consideration of the information supplied by appellant, respondent denied his petition for reassessment, thereby resulting in this appeal.

The initial question with which we are presented is **whether appellant** received any income from illegal narcotics sales during the appeal period. Despite the fact that the criminal charges against appellant were dismissed, apparently because of a defective search warrant, we believe that the LAPD arrest reports which contain references to appellant's actions and statements, corroborating statements from one of appellant's purchasers, the narcotics and drug-related paraphernalia found in his residence, and the above mentioned records and unnegotiated checks, establish at least a prima facie case that appellant received unreported income from the illegal sale of controlled substances during the period in issue.

The second issue is whether respondent properly reconstructed the amount of appellant's income from all sources, including drug sales. 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 reconstruc-

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tion 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 view -of the inherent difficulty 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 32.6 (5th Cir. 1966); Appeal of Burr MacFarland 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 ensure that the taxing authority's reconstruction does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that 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 MacFarland 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. suborn., 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 MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976..)

As previously noted, respondent concluded that appellant's taxable income for the period in issue was \$239,745. For purposes of reconstructing his income from cocaine sales, respondent relied upon appellant's admissions, the extensive set of records he maintained of his sales, the unnegotiated checks seized at the time of his arrest, the results of the LAPD investigation, and other data obtained from the LAPD and the California

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Department of Justice. Specifically, respondent determined that appellant: (i) had been in the "business" of selling narcotics for at least eight months during 1977; (ii) sold cocaine for \$130 a gram; (iii) sold at least 2,664 grams of cocaine over the eight months period; (iv) realized gross income of at least \$346,265 from cocaine sales; and (v) had a standard cost of cocaine sold of \$40 per gram.

We believe that the evidence obtained from the LAPD investigation which led to, and culminated with, appellant's December 15, 1977 arrest, as summarized above, supports the reasonableness of the first four above mentioned assumptions. With regard to respondent's third assumption, while appellant's representative in this matter has stated that he is an "expert" as to the street price of cocaine and has asserted that cocaine sold for \$65 per gram in 1977, he has failed to explain why we should not rely upon his client's own records which clearly show a sales price of \$130 per gram. In the absence of any credible evidence to the contrary, we believe that respondent acted reasonably in relying upon appellant's records in fixing his sales price at \$130 per gram.

The fourth assumption in respondent's reconstruction formula concerns the amount appellant realized as gross income from cocaine sales. As set forth above, respondent determined that amount to be \$346,265. In arriving at that figure, respondent summarized the seized checks, which **totalled** \$172,650, and added that amount to the payments noted in appellant's records; the \$30,390 seized at the time of appellant's arrest was not included. While we believe it was reasonable for **respondent** to rely upon appellant's records in order to reconstruct his gross income from cocaine sales (see Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal.. July **29, 1981**), the **inclusion** of the unnegotiated checks in that computation requires further discussion.

As previously indicated, appellant originally claimed that the unnegotiated checks, all of which were drawn on Bradley's checking account, simply represented as "scorecard" of "inane" wagers, and that his possession of those checks was a "lark." Apparently recognizing the lack of credibility inherent in such an assertion, appellant now admits that he was the recipient of numerous checks from Bradley in 1977, and that he negotiated the checks when informed by Bradley that there were sufficient funds in his checking

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account. Since there never existed sufficient funds to negotiate the \$172,650 in checks seized at the time of his arrest, appellant argues, that amount may not be included in his gross income from cocaine sales.

Income is not realized by a cash basis taxpayer, like appellant, until he has the funds under, his dominion and control, free of any substantial restriction as to the use thereof. (M. & Fischer, 14 T.C. 792 (1950); Marion Otis Chander, 16 B.T.A. 1248 (1929).) The lack of **sufficient funds** in the payor's checking account constitutes such a substantial restriction. (L. M. Fischer, *supra*.) Notwithstanding this principle, however, appellant bears the burden of proving erroneous respondent's factual determination that the unnegotiated checks were not restricted. (See Appeal of Oscar D. and Agatha E. Seltzer, Cal. St. Bd. of Equal., Nov. 18, 1980.) To overcome the presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible evidence to support his assertions. When the taxpayer fails to provide such evidence, respondent's determinations **must** be upheld. (W. M. Buchanan, 20 B.T.A. 210 (1930); Appeal of James C. and Monablance A. Walshe, Cal. St. Bd. of Equal., Oct. 20, 1975; Appeal of David A. and Barbara L. Beadling, Cal. St. Bd. of Equal., Feb. 3, 1977.) **Careful** review of the record on appeal reveals that appellant has supplied no substantiation to support his assertion that Bradley's checks were restricted. Indeed, the evidence provided by appellant indicates that there were substantial funds in Bradley's checking account immediately prior to appellant's December 15, 1977 arrest. **Furthermore**, appellant's actions in this appeal would appear to indicate that he was in a **position** to obtain the information needed from Bradley to substantiate the assertion that the subject checks were restricted by virtue of insufficient funds in the latter's **checking** account.

Appellant admits that Bradley was a "very rich" individual who "spent large amounts of money on a regular basis." Yet he has provided no explanation to explain either: (i) why such a person would be passing unnegotiable checks; or (ii) why he would accept \$172,650 in checks he knew to be unnegotiable. The record of this appeal also shows that on the day prior to his arrest appellant cashed \$28,500 in checks drawn on Bradley's account. These factors, together with his conflicting statements regarding the checks, shake the credibility of appellant's current position that the

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checks were valueless. Finally, as discussed below, appellant's actions in this matter tend to indicate that if the funds in Bradley's account were insufficient to negotiate the seized checks, appellant was in a position to obtain the data needed to substantiate that point.

As part of his petition for reassessment, appellant was able to produce a declaration from Bradley less than two weeks after appellant's arrest. When respondent questioned the credibility of the statements found in that declaration, however, appellant's representative in this matter asserted that his client was unaware of Bradley's whereabouts. To document this claim, he provided respondent with a photocopy of an envelope **allegedly sent** to Bradley which had been returned by the postal authorities as undeliverable as addressed. Careful examination of this photocopy reveals that the letter was undeliverable in the manner addressed because it was not addressed to Bradley's correct address. The letter from appellant's representative to Bradley, in addition to not bearing a zip code, was addressed to 3200 Belview Dr., Los Angeles, California; Mr. Bradley's correct address, as shown on **the numerous** checks appellant received, was 3100 Belleview, No. 102, Los Angeles, California 90026. That appellant resorted to this apparent deception for the purpose of demonstrating that he was no longer in contact with Bradley tends to show the exact opposite. **Moreover**, it should be noted that, in a declaration dated December 2, 1981, appellant was able to provide information regarding the date Bradley closed his checking account; the manner in which he was able to acquire this information has remained unexplained, as **has the** "disappearance" of Bradley, who supposedly financed a production company in which appellant and his attorney were involved.

In the aggregate, these factors lead to the clear implication that appellant was; (i) aware of Bradley's whereabouts; and (ii) able to acquire information from Bradley when it was convenient for his purposes. Reliable data regarding the balance in Bradley's checking account would have constituted the type of tangible evidence needed to support appellant's assertion that the seized checks were restricted by insufficient funds. His failure or refusal to **produce** such documentation, even though represented by an attorney, bears heavily against him. (Halle v. Commissioner, 175 F.2d 500 (2d Cir. 1949), cert. den., 338 U.S. 949 [94 L.Ed. 586] (1950); Appeal of Oscar D. and Agatha E.

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Seltzer, supra.) Under these circumstances, we must accept as correct respondent's determination that the subject checks were unrestricted and that they constituted gross income to appellant at the time they were delivered to him.

The final component in respondent's reconstruction formula concerns the cost to appellant of cocaine he was selling. Based upon the following entry in his records'

780
-40 - C (emphasis added)
820

respondent concluded that appellant paid \$40 per gram; the emphasized 'C', it was determined, represented the term "cost." We are of the opinion that the record of this appeal does not support respondent's conclusion.

The subject notation was unique in appellant's records; it is inconceivable that only **one such** entry would appear in those records if appellant had in fact been keeping written records of his cost. **Moreover**, in view of the fact that the \$40 figure appearing next to the emphasized 'C' was added to what appears to have been payment for six grams of cocaine, it is **highly** unlikely that this entry dealt with appellant's basis in the cocaine he was selling. Finally, we note that emphasized portion of the entry in issue could easily denote other items, e.g., one of appellant's purchasers, a type of narcotic, or even a unit of measure (**i.e.**, centigram).

In a recent opinion of this board dealing with the propriety of respondent's reconstruction of income realized from narcotics sales, Appeal of Eduardo L. and Leticia Raygoza, decided July 29, 1981, we upheld **respondent's** use of reliable law enforcement data to sustain a determination that the taxpayers in that case had been selling their narcotics at a 100 percent profit. In the absence of credible evidence in this record regarding appellant's cost of "goods" sold, we believe it is proper to rely upon the data utilized by respondent in Raygoza. Accordingly, we conclude that it is reasonable to assume that appellant **purchased cocaine** for \$65 per gram.

By modifying respondent's reconstruction of appellant's cocaine-related taxable income, which was

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based solely upon the seized checks and payments noted in his records, in the manner set forth above, **appellant's** taxable income for the appeal period would **be** reduced to \$173,105. Our determination in this regard is not, however, dispositive of this appeal. The subject jeopardy assessment is based upon all taxable income to appellant during the period in issue, not merely the income reflected in the seized checks and appellant's records. The record of this appeal supports a finding that appellant had additional taxable income of \$34,390 during the appeal period. This income was derived from: (i) \$5,010 in welfare benefits appellant admits to having received during the appeal period; in view of his other income, the welfare benefits appear to have been fraudulently obtained, and therefore are taxable (Rev. Rul. 78-53, 1978-1 Cum. Bull. 22); (ii) \$14,200 in "loans" received by appellant in 1977 which he acknowledges constituted taxable income because repayment is highly unlikely; and (iii) an additional \$15,180 in taxable income from cocaine sales. (In **view** of the circumstances of this appeal, we believe that the \$30,390 seized at the time of appellant's arrest represented gross income from the sale of **234** grams of cocaine. Through use of respondent's reconstruction formula, as modified herein, appellant's taxable income from those sales was \$15,180.)

For the reasons set forth **above**, we conclude that appellant received a total of \$207,495 in unreported taxable income from all sources, including illegal narcotics sales, during the appeal period. Respondent's jeopardy assessment shall be modified accordingly.

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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 Philip Marshak for reassessment 'of a jeopardy assessment of personal income tax in the amount of \$25,472 for the period January 1, 1977, through December. 15, 1977, 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 31st day of ~~March~~ , 1982, by the State Board of Equalization, with Board Members Mr. Reilly, Mr. Dronenburg, and Mr. Nevins present.

_____, Chairman
· George R. Reilly _____, Member
· Ernest J. Dronenburg, Jr. _____ | Member
Richard Nevins _____, Member
_____ , Member