BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAMPSON DIXON)

Appearances:

For Appellant: Nathan Goller
Mark Gottesman
Attorneys at Law

For Respondent: Mark McEvilly
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 Sampson Dixon for reassessment of jeopardy assessments of personal income tax in the amounts of $5,494, $24,647, and $3,102 for the periods October 1, 1975 through December 31, 1975, the year 1976, and January 1, 1978 through February 28, 1978, respectively, and pursuant to section 19057, subdivision '(a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Sampson Dixon for refund of personal income tax in the amount of $23,723 for the year 1977.

Appeal of Sampson Dixon

The issues presented by this appeal are the following: (i) whether responaent has properly reconstructed appellant's income from heroin sales during the appeal period; and (ii) whether respondent is precluded from utilizing information obtained a!; a result of an *oral* hearing conducted pursuant to Revenue and Taxation Code section 18645 to support its actions in this matter. In order to properly consider these issues, the relevant facts concerning appellant's arrest and the subject jeopardy assessments are set forth below.

On January 26, 1978, Officer D.J. Harrison of the Administrative Narcotics Division for the Los Angeles. Police Department ("LAPD") received information from another LAPD narcotics officer to the effect that appellant was engaged in the sale of heroin.. This information had been supplied by a confidential reliable informant who admitted that he had been purchasing heroin from appellant for one year, the most recent such purchase having occurred on January 11, 1978. On the same day he received this report, Officer Harrison obtained identical information from an official of the Santa Monica Police 'Department. The latter informed Harrison. that another confidential reliable informant had acknowledged that he too had been purchasing heroin from appellant and one of appellant's "agents," one Roberta Armer. The reliability of both informants was established by virtue of other information they had previously supplied to law enforcement officials leading to numerous arrests and the seizure of narcotics.

During the course of the LAPD's independent investigation of appellant's activities, Ms. Armer was observed to be engaged in what appeared to experienced narcotics officers to be the sale of controlled substances; it was evident from this surveillance that Ms. Armer was working in concert with appellant. On February 15, 1978, Officer Harrison interviewed a confidential informant who acknowledged having purchased. heroin from appellant at the latter's residence located at 805 Brooks Avenue in Venice *over* a considerable period, and that the most recent such purchase had occurred two days earlier. Based upon his investigation, which included additional surveillance of Ms. Armer, surveillance of appellant, interviews with the informants described above, and other preliminary investigatory work, Officer Harrison requested, and obtained, a warrant authorizing, inter alia, the search of appellant's residence as well as Ms. Armer's apartment.

On March 2, 1978, appellant was intercepted on the street by law enforcement officers and was taken to his above indicated residence. As they approached the door and identified themselves, the officers heard footsteps running away from the *door*. Fearing that evidence might be destroyed or that the occupants would attempt to arm themselves, the officers forced entry. During their search of the house and accompanying garage, the officers discovered, among other things, 154 grams of heroin, significant quantities of other narcotics,

marijuana, various items characteristic of a drug selling operation, and $54,875 in currency. Upon the conclusion of the search, appellant and three other persons in the house, including Ms. Armer, were arrested. Upon being advised of his constitutional rights, appellant made the following statement to the arresting officers:

> The heroin you found in the carpets in the garage was put there by me. It's my dope. I have been waiting for 4 weeks for you guys to come. Someone told me that [the] Santa Monica [Police Department] was going to come with a search warrant, so I put it in the carpets. I have been selling heroin since I got out of prison on that murder charge [in 1972]. . . .

The subsequent search of an apartment used by appellant uncovered a gun and more narcotics; drug paraphernalia and a small amount of heroin were found in Ms. Armer's apartment.

Based on the above, criminal charges were filed against appellant for possession of heroin and possession of controlled substances for sale. The criminal charges against appellant were later dismissed when it was determined that the authorities had exceeded the limits of the search warrant granted to search appellant's residence.

Respondent was notified of appellant's arrest on or about March 2, 1978. In view of the circumstances described above, it was determined that collection of appellant's personal income tax liability would be jeopardized by delay; respondent subsequently issued appellant a jeopardy assessment for the year 1977. In issuing its jedpardy assessment, respondent found it necessary to estimate appellant's income for that year. Utilizing the then available evidence, respondent determined that appellant's total taxable income from heroin sales in 1977 totaled $661,024, with a resultant tax liability of $71,813. Pursuant to section 18817 of the Revenue and Taxation Code, respondent received from the LAPD $54,839 of the $54,875 seized at the time of appellant's arrest; an additional $1,307 was later obtained from the Santa Monica Police Department.

The evidence relied upon by respondent in reconstructing appellant's income was derived from the results of the police investigation and ensuing arrest. Based upon that data, respondent computed appellant's income for 1977 on the assumption that he sold 16 ounces of heroin per week at a sales price of $1,135 an ounce, thereby resulting in gross annual income of $944,320. That amount was then reduced to reflect appellant's estimated cost of "goods" sold, $283,296, to arrive at taxable income of $661,024.

On March 14, 1978, appellant filed a petition for reassessment of the previously issued jeopardy assessment. In his petition, appellant requested that respondent grant him an oral hearing pursuant to section 18645 of the Revenue and Taxation Code. The oral hearing was conducted in Sacramento on February 20, 1979; appellant, his attorneys, and three of respondent's representatives were present. In variance from its general practice, and at the specific request of appellant's attorneys, the hearing was not recorded. The only record of this meeting consists of the written notes taken by respondent's representatives. Our review of those notes reveals no inconsistency between what each of those representatives noted.

Appellant commenced the February 20, 1979 hearing by reading a prepared statement which he has acknowledged was drafted by his attorneys; respondent was not provided a copy of this statement. In this prepared statement; appellant disclosed that, in addition to selling heroin, he was involved in two legitimate ventures: the distribution of newspapers and a janitorial business. Appellant further stated that he hired heroin addicts to work in his janitorial business and that, while he paid them no wages, he dia provide them food, clothing, and shelter, as well as supplying the heroin needed for their habits. Finally, appellant disclosed that he purchased one ounce of heroin each week, "cut" this heroin with two parts of lactose, and sold this amount personally. Appellant acknowledged that he made a weekly profit of $1,300 from these direct sales.

Following the reading of the prepared statement, appellant answered a host of questions posed by respondent's representatives. In response to these questions, which by all accounts were answered in an extremely candid manner, a number of pertinent facts emerged. Specifically, the following information was disclosed: (i) appellant stated that he paid $1,200 an ounce for the heroin he purchased- and that a "street ounce" of heroin consisted of 25 grams; (ii) appellant had been engaged in the sale of heroin since at least "the time of Troy Thompson's demise," later identified as August 1975 when Mr. Thompson was arrested and forced out of the "business" of dealing in narcotics; (iii) that, in addition to the heroin sales referred to in his prepared statement, appellant also sold heroin to the addicts employed in his janitorial service at $50 for three "balloons" each containing 1/2 gram of the drug, and that his employees required an average of 36 such balloons daily; and (iv) that appellant made additional "consignment" sales of these balloons to his employees at $10 per balloon in order that they could resell: them at a profit so as to pay for the heroin needed to satisfy their own addictions.

Based upon appellant's statements at the February 20, 1979 hearing, together with supporting evidence otherwise acquired, including: (i) a review of appellant's 1975 and 1976 California personal

income tax returns (returns were not filed for 1977 and 1978); (ii) financial statements supplied by appellant; (iii) an examination of appellant's known bank accounts showing deposits of almost $100,000 during the period 1975 through 1978; and (iv) evidence revealing that appellant made down payments totaling $16,000 for two vehicles, as well as investing substantial amounts in second trust deeds and real estate without concurrent withdrawals from his savings accounts, respondent revised its original estimate of appellant's narcotics-related income for 1977. While, as previously noted, respondent originally calculated that appellant was selling one pound of heroin a week and that he had been engaged in this activity only during 1977, subsequent to the February 20, 1979 hearing, respondent devised the computation which forms the subject of this appeal. Specifically, respondent determined that: (i) appellant had been in the "business" of selling heroin from October 1, 1975 through February. 28, 1978; (ii) appellant's cost of "goods" sold was $1,200 an ounce; (iii) appellant was personally selling one ounce of heroin, "cut" with two parts lactose' per week at a profit of $1,300; (iv) that appellant derived a weekly profit of $2,184 from heroin sales to the heroin addicts employed by him in his janitorial service; and (v) that appellant realized additional taxable income of $840 a week from the previously described "consignment" sales. The summary of this computation resulted in an annual profit of $224,848.

Based upon the above conclusions, respondent revised its original jeopardy assessment for 1977 to reflect taxable income in the above amount, with a resultant tax liability of $23,723. Furthermore, as a result of appellant's admission that he had been selling from at least October 1, 1975 through the date of his aforementioned arrest, respondent issued jeopardy assessments for' the other periods in issue in the subject amounts. Respondent subsequently denied appellant's petition for reassessment for the periods involved for the years 7975, 1976, and 1978. A portion of the funds obtained by respondent pursuant to section 18817 was then applied to the jeopardy assessment issued for 1977. A claim for refund in the amount of $23,723 was then filed by appellant for the year 1977; that claim was denied by respondent.

The initial question with which we are presented is whether respondent properly reconstructed the amount of appellant's income from heroin 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.TaxR.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 C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In view of the 'inherent difficulties 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 MacFarland Lyons, Cal. St Bd. of Eaual . . Dec. 15, 1976.) It has also 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 nut 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. 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 MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

As previously noted, respondent concluded that appellant's annual taxable income over the course of the appeal period was $224,848. For purposes of reconstructing his income from heroin sales, respondent relied heavily upon appellant's own admissions, as well as

the other evidence referred to above. Based upon this data, respondent arrived at the five aforementioned factors which form the basis of its reconstruction formula. After careful review of the record on appeal, we believe that the relevant evidence supports the reasonableness of each of the elements set forth above. While the first three elements are based upon appellant's own explicit admissions and do not require detailed elaboration 1/, we believe the remaining two factors require additional discussion.

1/ The second element in respondent's reconstruction formula pertains to appellant's cost of "goods" sold. While in previous such cases respondent has allowed taxpayers engaged in the illegal sale of controlled substance: to deduct the cost of the narcotics solo from their gross income, this deduction is now statutorily prohibited. Revenue and Taxation Code section 17237.5, effective September 14, 1982, provides, in pertinent part, as follows:

> (a) In computing taxable income, no deductions (including deductions for cost of goods sold) shall be allowed to any taxpayer on any of his or her gross income directly derived from illegal activities as defined in Chapter 4 (commencing with Section 211) of Title 8 (commencing with Section 314) of Title 9 of, or Chapter 2 (commencing with Section 459), Chapter 4 (commencing with Section 484), or Chapter 5 (commencing with Section 503) of Title 13 of, Part 1 of the Penal Code, or as defined in Chapter 6 (commencing with Section 11350) of Division 10 of the Health and Safety Code; nor shall any deductions be allowed to any taxpayer on any of his or her gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, those illegal activities.
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> (c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res juaicata, or otherwise.

The sale of controlled substances, including herion, constitutes an illegal activity as defined by Chapter 6 of Division 10 of the Health and Safety Code. (Health & Saf. Code, § 11350 et seq.) Accordingly, no deduction for appellant's cost of goods sold is allowable.

The fourth assumption in respondent's reconstruction formula concerns the profit realized by appellant from heroin sales made to the employees hired by his janitorial service. As set forth above, respondent determined that appellant made a weekly prof'it of $2,184 from such sales.' In arriving at that figure, respondent relied upon appellant's statement that he sold an average of 36 1/Z-gram balloons to his employees each day. Based upon a sales price of $50 per three balloons, respondent computed that appellant realized $600 gross income per day from these sales. Finally, each "cut" ounce of heroin admittedly cost appellant $400 and was sufficient to package 50 balloons, thereby resulting in a cost per balloon of $8. Accordingly, respondent determined that appellant realized a $26 profit from each three-balloon sale, or $312 from the twelve such sales made daily to his employees, thereby resulting in a weekly profit of $2,184.

The fifth assumption concerns the profit realized by appellant from the "consignment" sales described above. Appellant stated at the February 20, 1979 hearing that he provided additional balloons of heroin to his employees at $10 per balloon in order that they could sell them at a profit, thereby enabling them to purchase the heroin needed to supply their own habits. Using a conservative formula, respondent determined that appellant's employees would need to sell 60 such balloons a day at a 100 percent profit in order to make the $600 they needed each day ta pay for their heroin addictions. Using the same $8 per balloon cost figure referencea above, respondent computed that appellant made a $2 profit per balloon sold on a "consignment" basis. Based upon projected sales of 420 such balloons per week, appellant realized $840 profit from these sales. The 100 percent profit margin attributeito the sales made by appellant's employees is supported by reliable law enforcement data previously utilized by this board in cases of this type. (Appeal of Eduardo L. and Leticia Raygoza, Cal.St. Bd. of Equal., July 29, 1981; Appeal of Philip Marshak, Cal. St. Bd. of Equal., March 31, 1982.)

Notwithstanding our conclusion that respondent's reconstruction formula is reasonable, and that each of the elements thereof has a basis of evidentiary support in the record of this appeal, we are cognizant that appellant!s presentation at the hearing conducted before this board on June 16, 1982 conflicted with the evidence relied upon by respondent. Upon careful review of the transcript of that oral hearing, however, we believe that the numerous internal inconsistencies both in appellant's testimony and the arguments advanced by hi:; attorneys undermine the credibility which might otherwise be attributed thereto, and that, in no event, has appellant borne his burden of proving respondent's reconstruction erroneous. Finally, as discussed below, even were we to accept at face value the central argument advanced by appellant, i.e., that he sold only. one "uncut" cunce of heroin per week, we would sti 11 have to conclude that respondent properly computed his taxable income.

Before this board, appellant's representatives alleged that their client purchased one "uncut" ounce of heroin per week, that his basis in that heroin varied from $1,200 to $1,500, and that he sold his heroin for $2,400 to $3,000 an ounce. Moreover, they acknowledged that appellant made an additional $700 profit per week frcxn sales to his janitorial employees. Despite the obvious conclusion to be drawn from their own figures, i.e., that appellant realized a weekly profit of from $1,900 to $2,200 from heroin sales, appellant's representatives contended, at various points in the hearing, that appellant earned only $500 to $1,000 per week from such sales. Not only was the position advanced by appellant's attorneys internally inconsistent, it conflicted with their clients' testimony that his weekly purchases of heroin "kept climbing higher and higher" than one ounce per week.

There exists an abundance of other such inconsistencies in the record of the hearing conducted before this board. For example, at one point, appellant stated that he "gave" heroin to his employees, thereby contradicting his representatives' earlier statement that he made a $700 weekly profit from sales to his employees. Later, however, appellant acknowledged that "... well, I guess it was selling [heroin]." Finally, appellant seemingly acknowledged his unfamiliarity with the information contained in the prepared statement he read at the aforementioned February 20, 1979 hearing by testifying that he had only saia "[w]hatever [my attorneys] tola me to say."

The principal position advanced by appellant's representatives at the June 16, 1982 nearing was that the subject assessments should be reduced by 50 percent because their client haa purchasea only one ounce of heroin per week, rather than the two ounces attributed to him by respondent. As noted above, however, appellant's own testimony was that his heroin purchases "kept climbing higher and higher" than one ounce per week. However, even were we to accept as accurate the assertion that he purchased only one ounce per week, the computation of appellant's taxable income from heroin sales would remain unaltereo. Respondent relied upon appellant's earlier statements that he packaged his heroin in 1/2-gram balloons; at the hearing before this board, however, appellant testified that each balloon contained only 1/4 gram of heroin. Accordingly, his profit per ounce would double on the basis of purchases of one ounce per week, thereby resulting in the same amount of taxable income as under respondent's computation.

The second issue presented by this appeal concerns appellant's argument that respondent is precluded from utilizing the information obtained from the February 20, 1979 hearing to support its actions in this matter. In support of this proposition, appellant has cited section 1152 of the Evidence Code. Additionally, appellant cites section 11513 of the Government Code to support his contention that the above referenced hearing did not comply with the requirements of an

"administrative hearing." After consideration of these contentions, we conclude that appellant's arguments are without merit and that respondent is not precluded from using the evidence obtained at the referenced hearing to sustain its actions in this appeal.

The February 20, 1975 hearing was conducted pursuant to Revenue and Taxation Code section 18645 upon appellant's request.. That section provides in relevant part, as follows:

> If a petition for reassessment is filed, the Franchise Tax Board shall reconsider the jeopardy assessment and, if the taxpayer has so requested in his petition, the Franchise Tax Board shall grant him or his authorized representative an oral hearing. ...

Nothing in the quoted section, precludes respondent from utilizing information obtained in such a hearing. Furthermore, section 1152 of the Evidence Code is irrelevant to this appeal; that statute pertains to the admissibility of evidence of compromise offered by one party to another party claiming to have sustained damage or loss. The evidence offered by appellant-was offered in a hearing conducted for the purpose of ascertaining his personal income tax liability and not in compromise of an alleged loss or damage. Finally, appellant's citation of section 11513 of the Government Code is equally irrelevant. That section sets forth certain hearing requirements applicable to the agencies referred to in section 11501; neither respcnaent nor this board are referred to in section 11501.

For the reasons set forth above, respondent's actions in this matter will be sustained.

Appeal of Sampson Dixon

ORDER

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 Sampson Dixon. for reassessment of jeopardy assessments of personal income tax in the amounts of $5,494, $24,647, and $3,102 for the periods October 1, 1975 through December 31, 1975, the year 1976, and January 1, 1978 through February 28, 1978, respectively, be and the same is hereby sustained and that, pursuant to section 19060 of the Revenue and Taxation Code, the action of the Franchise Tax Board in denying the claim of Sampson Dixon for refund of personal income tax in the amount of $23,723 for the year 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of November, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevinspresent.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member