

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CLARENCE LEWIS RANDLE, JR.)

For Appellant: Norman Edell
Attorney at Law

For Respondent: Mark McEvelly
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 Clarence Lewis Randle, Jr. for reassessment of a jeopardy assessment of personal income tax in the amount of \$12,593.00 for the period January 1, 1973 through November 16, 1978.

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The issues presented by this appeal are the following: (i) did appellant receive unreported income from the illegal sale of cocaine during the appeal period; and (ii) if so, did respondent properly conclude that appellant had \$122,667 in taxable income from such 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 14, 1978, Officer Richard Lamascus of the Los Angeles Sheriff's Office ("LASO") received information from a confidential informant ("CI") to the effect that appellant was engaged in the sale of cocaine. The CI admitted to having purchased cocaine from appellant on at least five occasions over the previous three months; he also stated that appellant always maintained an inventory of cocaine for sale. Under the supervision and surveillance of LASO officers, the CI concluded a carefully controlled purchase of .11 grams of cocaine from appellant on November 14, 1978; \$50 in police-supplied funds were used to pay for the cocaine. Based upon information supplied by the CI, the controlled purchase of cocaine from appellant, and additional preliminary investigatory work, Officer Lamascus requested, and obtained, a search warrant for appellant's residence.

On November 16, 1978, LASO deputies went to appellant's residence for the purpose of serving the search warrant. Appellant opened his door before the officers could request entrance. Upon observing the deputies, however, appellant slammed the door shut. Fearing that appellant would attempt to destroy evidence or arm himself, the deputies 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 uncovered, among other things, a total of 78.1 grams (approximately 2.8 ounces) of cocaine, one-half block of mannite (an agent used by narcotics dealers to "cut" cocaine); a small amount of phencyclidine (often, referred to as "PCP" or "angel dust"), quantities of liquid demoral, hashish, and hashish oil, 1,037 grams (approximately 2.3 pounds) of marijuana, 7 "Thai Sticks" (specially wrapped, high-grade marijuana), 20 "Shermans" (vernacular for a marijuana or tobacco cigarette) soaked in PCP, weapons, various items of stolen electronic and photographic equipment (narcotics dealers frequently trade drugs for stolen property), and numerous items characteristic of a narcotics selling operation, including a sensitive weight scale and packaging materials. Additionally, bankbooks issued in appellant's name, showing balances totaling \$10,010.13, were found in a safe; \$4,184 in currency was also discovered. Finally, two notebooks containing what an experienced narcotics enforcement official concluded were records "regarding large scale narcotics transactions" were also found. Appellant was arrested upon the conclusion of this search and charged with possession of cocaine, phencyclidine, and marijuana for sale, six separate charges of possession of various controlled substances, and one charge each for possession of narcotics paraphernalia and receiving stolen property.

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Respondent was informed of the aforementioned events on the day following appellant's arrest. Officer Lamascus related to respondent's representative that, according to the CI, appellant had been selling at least four ounces of cocaine a week, at a minimum sales price of \$2,000 per ounce, for the previous two years. Respondent's subsequent review of appellant's personal income tax returns for that period, filed under single, unmarried status, revealed that appellant had not reported any taxable income from narcotics sales. In view of the circumstances described above, it was determined that collection of appellant's personal income tax liability resulting from such sales 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 from cocaine sales for the 46-week appeal period. Utilizing the available evidence, respondent determined that appellant's cocaine-related taxable income was \$122,677.

The data relied upon by respondent in reconstructing appellant's income was derived from the results of the LASO investigation and from information obtained from the Bureau of Narcotic Enforcement ("BNE") of the Department of Justice. Based upon the above, respondent advised two alternative methods of reconstructing appellant's income from cocaine sales. Those computations are as follows: (i) respondent accepted as credible the CI's information that appellant had been selling four ounces of cocaine a week, but attributed a conservative sales price of \$1,000 an ounce to those sales. Based principally upon the CI's statement that appellant had been selling cocaine for two years prior to his arrest, respondent determined that it was reasonable to assume that appellant had been dealing in cocaine since at least January 1, 1978. Finally, relying upon an estimate apparently supplied by LASO officials, respondent concluded that appellant was purchasing cocaine at a price equal to one-third of his sales price; (ii) respondent's second computation differs from the first reconstruction only with respect to the volume of cocaine sales and appellant's sales price. Under this reconstruction formula, respondent determined that appellant was selling two ounces of cocaine a week at \$2,000 per ounce. Both formulas resulted in an identical amount of taxable income from appellant's alleged cocaine sales; income from other narcotics sales was disregarded.

In the criminal prosecution arising out of his arrest, appellant entered a plea of nolo contendere to the three charges of possession of controlled substances for sale; a plea of guilty was entered as to the remaining charges. Appellant's representatives in this matter have acknowledged that their client's manner of pleading to the charges against him resulted from a plea bargain. Appellant received a prison sentence followed by a period on probation.

Pursuant to section 18817 of the Revenue and Taxation Code, respondent obtained the funds needed to satisfy the amount of the jeopardy assessment from the LASO and appellant's known bank accounts;

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appellant subsequently filed a petition for reassessment; In answer to respondent's request that he furnish the information needed to accurately compute his income, appellant filed a Statement of Financial Condition in which he claimed that he had been temporarily laid off by his employer prior to his arrest, but had nevertheless received wages of \$12,000 during the appeal period. In an accompanying financial questionnaire, appellant stated that he and his wife, a school teacher, earned approximately \$25,000 per year; the bank balances and currency seized at the time of his arrest represented accumulated savings "over the past several years." Appellant offered no explanation why he had filed his past returns as a 'single, unmarried individual, nor did he supply his spouse's social security number, alleging that the latter was "unknown."

As part of his petition for reassessment, appellant claimed that he had not engaged in the sale of narcotics and that the controlled substances found in his apartment belonged to friends who stored their narcotics there; no explanation was supplied as to why appellant's "friends" maintained their drug inventories at his residence, nor why he permitted them to do so. Finally, appellant explained that the \$4,184 found in his safe represented funds "available in the event of an emergency." Appellant filed his 1978 return on April 15, 1980. Again, appellant filed as a single, unmarried individual; he declared gross income of \$5,781.28. Appellant has not explained why the gross income declared on his 1978 return conflicts with the \$12,000 reported on the aforementioned Statement of Financial Condition, nor has he supplied any data to verify that he is, or was, married, or explain why he has filed all of his returns as an unmarried individual. Appellant's petition for reassessment was denied by respondent, thereby resulting in this appeal.

The initial question with which ye are presented is whether appellant received any income from cocaine sales during the appeal period. After careful review of the record on appeal, we find appellant's contention that he was not engaged in the sale of narcotics, but was, merely allowing his friends to store controlled substances in his apartment, to be less than persuasive. The LASO arrest report and Officer Lamascus' request for a search warrant, which contain references to appellant's actions, corroborating statements from one of appellant's purchasers, the aforementioned controlled purchase of cocaine from appellant, the narcotics, and drug related paraphernalia and records found in appellant's apartment, establish at least a prima facie case that appellant received unreported income from the illegal sale of narcotics during the period in issue.

The second issue is whether respondent properly reconstructed the amount of appellant's taxable income from 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

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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 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 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), affa. 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.)

For purposes of reconstructing appellant's income, respondent relied upon an examination of his known bank accounts, the arrest report and search warrant request, additional information supplied by the LASO, the CI's statements and admissions, and data provided by the BNE. While, as previously noted, respondent devised two alternative

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methods of computing appellant's income, we believe that it is evident from its arguments on appeal that respondent is principally relying upon the second alternative. Specifically, respondent determined that: (i) appellant sold his cocaine for \$2,000 an ounce; (ii) appellant sold at least two ounces of cocaine per week; (iii) appellant had been in the "business" of selling cocaine from at least the beginning of 1978; and (iv) the average cost of "goods" sold was equal to one-third of his selling price.

In essence, appellant challenges the subject jeopardy assessment as being arbitrary. In this regard, appellant contends that respondent has unduly relied upon the CI's statements regarding appellant's activities. Moreover, appellant charges that the CI is unreliable because he had been under investigation by law enforcement authorities and was offered leniency in exchange for information. Finally, appellant contends that he was never charged with possession of controlled substances for sale, that he had only five grams of cocaine in his possession at the time of, his arrest, and that this amount was for his own use.

We believe that the evidence obtained from the LASO investigation which led to, and culminated with, appellant's arrest and conviction, together with additional supporting evidence, supports the reasonableness of the first three elements of respondent's reconstruction formula; Respondent's determination that appellant sold his cocaine for \$2,000 an ounce is buttressed not only by the information obtained from the CI, but also by data supplied by the BNE. The latter reveals that the "street" price of cocaine in appellant's area of activity varied from \$1,500 to \$2,300 during 1977 and 1978, and thereby supports the reasonableness of, respondent's estimate. Additionally, in the controlled purchase referred to above, appellant sold .11 grams of cocaine for \$50; projected to equal one ounce, the cumulative total of such sales would substantially exceed \$2,000 an ounce. With regard to the second factor in the reconstruction formula, the fact that appellant was found in possession of somewhat less than three ounces of cocaine ^{1/} supports respondent's estimate of sales of two ounces per week. In a previous appeal dealing with an identical issue, we upheld as reasonable respondent's conclusion that narcotics dealers will turn over their inventory once a

1/ In contradiction to appellant's contention that only five grams of cocaine were found in his apartment at the time of his arrest, the arrest report filed by Officer Lamascus clearly reveals that a total of 78.1 grams of cocaine were discovered. Furthermore, appellant is in error in stating that he was never charged with possession of controlled substances, including cocaine, for sale. The arrest report lists all eleven charges filed against appellant, including three charges for possession of various controlled substances for sale. Moreover, in the financial questionnaire he filed with respondent, appellant acknowledged that he had pled *nolo contendere* to the charges of possession for sale.

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week. We found that conclusion to be reasonable because in view of "the risks inherent in the illegal 'drug business, it [is] reasonable to assume that a dealer would only have on hand the amount of drugs which could be [disposed of] easily and quickly. ..." (Appeal of Clarence P. Conder, Cal. St. Bd. of Equal., May 15, 1974.) Moreover, the estimate of two ounces of sales per week is conservative-in light of the CI's statement that appellant's weekly sales of cocaine totaled four ounces.

The third element of the reconstruction computation, which concerns the duration of the projection period, is principally based upon the CI's statement that appellant had been dealing in cocaine for two years prior to his arrest, and is buttressed by the CI's admitted purchases of cocaine from appellant for three months and appellant's bank deposits and accumulated funds of \$12,440.52 over the appeal period. We believe that these factors, when viewed in the aggregate, are sufficient to induce a reasonable belief that appellant was trafficking in cocaine for at least the 46-week appeal period.

Appellant has sought to undermine the reliability of the information obtained from the CI by alleging that the latter was promised leniency on charges pending against him in exchange for information, and that the CI may have lied in order to derive the benefit of this "deal." Appellant's contention that charges were pending against the CI is devoid of any support in the record. Appellant's allegation presupposes that he is aware of the CI's identity whereas the record clearly shows that the latter's identity was kept confidential by the LASO because he feared for his safety if his identity were revealed. While the CI's reliability had not been tested at the time Officer Lamascus applied for the search warrant, the information that he supplied proved to be accurate and ultimately resulted in the seizure of narcotics and appellant's arrest and subsequent conviction. The furnishing of such accurate information to law enforcement authorities is used to establish the reliability of informants. (See Appeal of Eduardo L. and Leticia Raygoza, Cal. St. Bd. of Equal., July 29, 1981, wherein the reliability of a confidential informant was established based on his past record of supplying information resulting in arrests, convictions, and the seizure of narcotics.) Finally, there exists established authority for reliance upon data acquired from informants to reconstruct a taxpayer's income from illegal activities, provided that there do not exist "substantial doubts" as to the informant's reliability. (Cf. Nolan v. United States, 49 Am.Fed.Tax R.2d 89-941 (1982).) The record this appeal provides no basis for finding that the CI was unreliable. Rather, as previously noted, there is every reason to indicate that he was reliable since the information he supplied the LASO resulted in the seizure of narcotics, and appellant's arrest and conviction. Accordingly, we believe the CI's statements are sufficient to induce a reasonable belief that appellant was engaged in the "business" of selling cocaine from at least January 1, 1978. Finally, it should be noted that appellant has offered no credible explanation for the deposit of \$8,266.52 in his known bank accounts during the appeal period, nor the acquisition of the \$4,184 in currency seized at the time of his arrest.

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The final component in respondent's reconstruction formula pertains to the cost to appellant of the cocaine he was selling. Apparently based upon a police estimate that appellant "cut" each ounce of cocaine he purchased to produce three marketable ounces, respondent allowed appellant a cost of "goods" sold equal to one-third of his gross income from cocaine sales.

While in previous such cases respondent has allowed taxpayers engaged in the illegal sale of controlled substances to deduct the cost of "goods" sold from gross sales to arrive at their taxable income, this deduction is now statutorily prohibited. Revenue and Taxation Code section 17297.5, 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 of, Chapter 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.

* * *

(c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.

The sale of controlled substances, including cocaine, 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.

Based upon the above, we, conclude that appellant received a total of \$184,000 in unreported taxable income from the illegal sale of cocaine during the appeal period. This is substantially in excess of the amount originally computed by respondent, and is sufficient to sustain the subject jeopardy assessment in its entirety.

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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 Clarence Lewis Randle, Jr. for reassessment of a jeopardy assessment of personal income tax in the amount of \$12,593.00 for the period January 1, 1978 through November 16, 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of December, 1982; by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr, Nevins present.

<u>William M. Bennett</u>	Chairman
<u>Ernest J. Dronenburg, Jr</u>	Member
<u>Richard Nevins</u>	Member
<u> </u>	Member
<u> </u>	Member

