

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
HUMBERTO VARELA, JR.)

For Appellant: Donald A. Ainslie
Attorney at Law

For Respondent: John A. Stilwell, Jr.
Counsel

O P I N I O N

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 Humberto Varela, Jr., for reassessment of a jeopardy assessment of personal income tax in the amount of \$13,839.00 for the period January 1, 1980, through September 29, 1980.

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The following issues are presented by this appeal: (i) whether appellant received unreported income from the illegal sale of cocaine during the appeal period; and (ii) if so, whether respondent properly concluded that appellant had \$135,000 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 September 29, 1980, officials of the Vice/Narcotics Bureau of the Glendale Police Department ("GPD") received information from an anonymous informant that there were visible marijuana plants growing on the balcony of appellant's apartment. The two officers sent to appellant's residence to investigate, while able to observe the plants from the street, discovered that no one was inside the apartment at that time. Later that day, another attempt was made to contact appellant; this time, a Mr. Scittadano answered the door of appellant's apartment. The officers dispatched to investigate identified themselves and, from the doorway, were able to observe the marijuana plants on the balcony. Mr. Scittadano explained that the plants did not belong to him, that he was only visiting the apartment, and that no one else was at the residence at the time. When one of the two officers, Officer De Pompa, requested permission to enter, Mr. Scittadano again stated that he did not own the plants and began to walk into the interior of the apartment out of the officers' view. Fearing that Scittadano would attempt to destroy evidence or arm himself, the officers stepped into the apartment to maintain visual contact with him. As they entered the apartment, the officers observed a number of items used in the preparation of cocaine, as well as a quantity of the narcotic. At this point, the officers informed Scittadano that they would remain in the apartment, apply for a telephonic search warrant, and wait until the occupant returned.

Approximately one hour later, appellant arrived at his residence and was confronted by the two officers. The officers explained the reason for being at the location and the reason for the investigation. They then asked appellant for permission to search the interior of the apartment for cocaine, other controlled substances, or any narcotics-related paraphernalia. When appellant refused to grant such permission, the officers requested, and obtained, a telephonic search warrant and commenced their search.

During the course of the search, the officers uncovered, among numerous other items, a total of 3.3 grams of cocaine, a quantity of marijuana, numerous items characteristic of a narcotics selling operation, including a sensitive weight scale, and a massive array of jewelry. Additionally, a total of \$12,341 in currency was found in the apartment. Finally, records maintained by appellant of what appeared to be narcotics sales were also discovered. Upon the conclusion of this search, appellant was arrested and charged with possession of controlled substances for sale.

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Respondent was informed of the aforementioned events shortly after appellant's arrest. On October 8, 1980, Detective C. L. Brown of the Los Angeles Police Department sent respondent a report revealing that on May 9, 1979, he had spoken to an informant, a former personal friend of appellant, who stated that appellant was frequently in possession of large amounts of cash. He further stated that, on one occasion, he had observed ten kilograms of cocaine in appellant's vehicle, and explained that his friendship with appellant had been severed when the latter used the informant's residence, without approval, for a large scale cocaine transaction. On October 15, 1980, Agent R. L. Pierce of the GPD Vice/Narcotics Bureau provided respondent with a report noting that a confidential reliable informant had related to him that appellant: (i) had been engaged in the trafficking of cocaine for the previous 12 to 18 months; (ii) sold approximately two to four kilograms of cocaine per month at a price of \$10,000 per kilogram; and (iii) conducted his cocaine "business" from his automobile body shop.

In view of the circumstances described above, respondent determined that collection of appellant's personal income tax liability 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 appeal period. Utilizing the available evidence, respondent determined that appellant's cocaine-related taxable income was \$135,000.

Pursuant to section 18817 of the Revenue and Taxation Code, respondent obtained from the GPD the cash discovered in appellant's apartment on September 29, 1980; on October 30, 1980, appellant filed a petition for reassessment. Respondent thereupon requested that he furnish the information necessary to enable it to accurately compute his income, including income from the sale of controlled substances. When appellant responded to this request by submitting a financial statement and financial questionnaire utterly devoid of any information with respect to his income, and when neither he nor his representative appeared at the time and place specified for his protest hearing, his petition for reassessment was denied.

The record of this appeal reveals that, despite his assertion to the contrary, appellant has not filed California personal income tax returns for the years 1975 through 1980. With respect to the criminal charges resulting from his September 29, 1980, arrest, the record reveals that, in lieu of a trial, appellant entered an "early diversion" program, a program designed for narcotics offenders with few previous narcotics-related arrests.

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The initial question presented by this appeal is whether appellant received any income from the illegal sale of controlled substances during the period in issue. The reports submitted by Detective Brown and Agent Pierce, which contain references to appellant's actions and activities, the results of the aforementioned search of appellant's apartment, and the affidavit in support of the above mentioned telephonic search warrant establish at least a prima facie case that appellant received unreported income from the sale of cocaine during the appeal period.

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 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); Former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25, 1981.) 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

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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. t e d 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.)

The data relied upon by respondent in reconstructing appellant's income was derived from the results of the GPD investigation, an examination of the records maintained by appellant, and the reports submitted to respondent by Detective Brown of the Los Angeles Police Department and Agent Fierce of the GPD. Specifically, respondent determined that appellant: (i) had been engaged in the "business" of selling cocaine from at least January 1, 1980; (ii) sold cocaine for \$10,000 a kilogram; (iii) sold an average of three kilograms per month; (iv) realized gross income of at least \$270,000 from such sales during the appeal period; and (v) had a standard cost of "goods" sold equal to 50 percent of his selling price.

We believe that the statements of the confidential reliable informant to Agent Fierce, as summarized in the latter's report to respondent dated October 15, 1980, are credible and that, together with the other evidence obtained from the GPD investigation which led to, and culminated with, appellant's September 29, 1980, arrest, they support the reasonableness of each of the above elements of respondent's reconstruction formula. Moreover, we find that each of those elements is buttressed by evidence independent of the statements of the informants referred to in the reports of Detective Brown and Agent Pierce.

Initially, we reiterate that each of the elements of respondent's reconstruction formula, with the exception of the factor pertaining to appellant's cost of "goods" sold, is supported by the statements of the confidential reliable informant referred to in Agent Pierce's above mentioned report of October 15, 1980. There exists established authority for reliance upon data acquired from informants to reconstruct a taxpayer's income from illegal activities, provided

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that there do not exist "substantial doubts" as to the Informant's reliability. (Cf. Nolan v. United States, 49 Am.Fed.Tax R.2d 82-941 (1982); see also Appeal of Clarence Lewis Randle, Jr., Cal. St. Bd. of Equal., Dec. 7, 1982.) The record of this appeal provides no basis for finding that the informant was unreliable. **To the contrary, his** reliability had evidently already been established based on information he had previously provided to law enforcement authorities.

Respondent's determination that appellant was engaged in the sale of cocaine from at least January 1, 1980, is supported by the corroborating and independent statements of the informant referred to in Detective Brown's October 8, 1980, report as well as by the records maintained by appellant which were seized by the GPO on September 29, 1980. The earliest chronological entry in those records is January 3, 1980. The second element of the 'reconstruction formula pertains to appellant's selling price. Data supplied by the Western States Information Network, a Sacramento-based, federally funded law enforcement organization, reveals that the "street price" of cocaine in the Los Angeles metropolitan area in 1980 ranged from \$2,000 to \$3,000 an ounce; projected to equal one kilogram, the cumulative total would substantially exceed respondent's determination that appellant's selling price was only \$10,000 per kilogram.^{1/} The fact that funds representing the sale of over one kilogram were seized at the time of appellant's arrest supports the conclusion that he was selling at least three kilograms of cocaine each month. In this regard, it is relevant to note that, 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 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. Gonder, Cal. St. Bd. of Equal., May 15, 1974.) Finally, the determination that appellant's cost of cocaine sold was equal to 50 percent of his selling price is supported by reliable law enforcement data previously utilized by this

^{1/} This determination is further supported by information from the Bureau of Narcotic Enforcement of the Department of Justice which reveals that the "street price" for a kilogram of cocaine in the Los Angeles area varied from \$35,000 to \$45,000 in 1977 and 1978.

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board.^{2/} (Appeal of Eduardo L. and Leticia Rayqoza, Cal. St. Bd. of Equal., July 29, 1981.)

Again, we emphasize that **when a taxpayer fails to comply with the law in supplying the information required to accurately** compute his income, and respondent finds it necessary to reconstruct the taxpayer's income, some reasonable basis must be used. Respondent **must** resort to various sources of information to determine such **income** and **the** resulting tax liability. In such circumstances, a reasonable reconstruction of income will be presumed correct, and **the** taxpayer has the burden of proving it erroneous. (Breland v. United States, supra; Appeal of Marcel C. Robles, supra.) Mere assertions **by** the taxpayer are not enough to overcome that presumption. (Pinder v. United States, 330 F.2d 119 (5th Cir. 1964).) Given appellant's failure to provide any evidence challenging respondent's reconstruction of his income **from** cocaine sales, we must conclude that respondent reasonably reconstructed the amount of such income.

2/ 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.

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Based upon the above, we conclude that appellant received a total of \$270,000 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.

