BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MART CONRAD WENDE)

For Appellant: Craig A. Hattem
Attorney at Law

For Respondent: Mark McEvilly
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 Mart Conrad Wende for reassessment of jeopardy assessments, including a penalty for the year 1977, in the total amounts of $3,238.75 and $5,962 for the years 1977 and 1978, respectively.

The following issues are presented by this appeal: (i) whether appellant received unreported income from the illegal sale of controlled substances during the appeal years; [ii) if so, whether respondent properly concluded that appellant had $31,740 and $63,480 in taxable income from such sales for the years in issue, respectively; and (iii) whether respondent. properly assessed a 25 percent penalty against appellant for delinquent filing of his 1977 California personal income tax return. In order to 'properly consider these issues, the relevant facts concerning appellant's arrest and the subject jeopardy assessments are set forth below.

On the evening of January 15, 1979, Agent W. R. Flores of the Drug Enforcement Administration (DEA) of the United States Department of Justice was stationed at San Diego International Airport. Apparently based upon a "'profile" of individuals exhibiting behavior characteristic of those engaged in the trafficking of narcotics, Agent Flores-followed two men as they exited from an arriving flight. The two men were met by a third person, identified as "Mike," and the three left the airport in the latter's jeep. While Agent Flores lost-the jeep in traffic, he noted the vehicle's license plate arid was subsequently advised as to the name and address of the vehicle's registered owner.

Later that evening, the jeep was spotted at a local hotel, and the three men were seen at the hotel's registration desk. Shortly thereafter, two of the three departed, leaving behind their companion. The individual remaining at the hotel was subsequently identified with the assistance of DEA agents in Colorado as a suspected narcotics trafficker whose supplier had moved from Boulder, Colorado, to San Diego; the name of this individual has been deleted from the DEA report which constitutes part of the record of this appeal.

While the hotel room was placed under surveillance, other law enforcement officers went to the address of the jeep's registered owner. In addition to noting that the vehicle was at the location, the officers also witnessed a sports car arrive at the house. One of the three men seen earlier in the jeep, and later identified as one Gus Brose, exited the vehicle and entered the house. Shortly thereafter, the sports car was driven away by another individual. The vehicle was stopped by an El Cajon police officer for a license violation, and the driver was identified as appellant.

a

The next morning, approximately only 14 hours after arriving in San Diego, Mr. Brose and his unidentified companion were followed to the airport where they purchased tickets to Colorado Springs under assumed names. Before they could depart, however, they were approached by DEA agents and notified that they were the subject of a narcotics investigation; they were then detained and questioned. Both subjects consented to the search of their persons and luggage. Gus Brose was found to be in possession of approximately three ounces of cocaine; his companion was not carrying any controlled substances. Upon being placed under arrest, Brose related to the DEA agents that he had purchased the cocaine from appellant for $4,500. Brose further stated that he would have purchased more cocaine, but that appellant's supply was exhausted and that he would be able to provide more cocaine in "the next day or two." Upon conclusion of this questioning& Brose and his companion were charged with conspiracy and possession of cocaine with intent to distribute.

On February 28, 1979, deputies of the San Diego Sheriff's Department were summoned to an apartment in response to a reported auto theft. Upon arriving at the apartment, the deputies were told by Mr. Brose that he had purchased cocaine from appellant about one month earlier, and that the latter had just called upon him to collect approximately $2,400 still due from that transaction. Unable to recover payment from Brose, appellant and two companions had taken his vehicle without permission and under threat of force. On the same day, appellant was stopped by sheriff's deputies while driving Brose's automobile and placed under arrest for grand theft. At the time of his arrest, appellant was in possession of $2,487 in currency, checks totaling $1,030, and a ledger containing records maintained by appellant of what appear to be narcotics transactions. When questioned with respect to the nature of Brose's debt, appellant refused to elaborate, stating simply that it was "just a debt." Due to Brose's admission that he had purchased cocaine from appellant, the deputies contacted the DEA; Agent Flores advised the officers to impound the items taken at the time of appellant's arrest as evidence.

Agent Flores notified respondent of the above events on February 28, 1979. Flores related to respondent's representative that appellant's ledger had been reviewed by Brose, and that the latter acknowledged that his name appeared in the ledger, together with the names

of a number of other persons, in relation to the purchase of controlled substances. Brose also stated that he had first purchased cocaine from appellant in mid-summer 1977. A subsequent examination of the ledger entries revealed that they totaled $211,611.90.

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 j-eopardy assessments were subsequently issued: a 25 percent delinquent filing penalty was imposed for the year 1977 pursuant to Revenue and Taxation Code section 18681. In issuing the jeopardy assessments, respondent found it necessary to estimate appellant's income from the sale of controlled. substances. Utilizing, the available evidence, respondent determined that appellant's narcotics-related taxable income was $31,740 and $63,488 for the years 1977 and 1978, respectively.

Pursuant to section 18817 of the Revenue and Taxation Code, respondent obtained the cash discovered in appellant's possession at the time of his aforementioned arrest; later collection action resulted in the collection of'an additional $563.67. On April 5,. 1979, appellant filed a petition for reassessment. Respondent thereupon requested that he furni'sh the information necessary to enable it to accurately compute his income, including income from the sale of controlled substances. In response, appellant submitted a financial statement in which he claimed income of only $3,100 for 1977, zero income for 1978, and average monthly expenses of $900. Appellant provided no explanation'as to how he met his expenses with such an allegedly meager income. In addition, appellant disclosed no income from the sale of controlled substances. Upon examination of the material submitted by appellant, respondent denied his petition for reassessment, thereby resulting; in this appeal.

The record of this appeal reveals that appellant was not prosecuted for the charge upon which he was arrested on February 28, 1979. His attorney has acknowledged, however, that his client's probation 'arising out of a previous narcotics offense was revoked. The record also revealsthat, upon release from custody, appellant retrieved his ledger from law enforcement authorities.

The initial question presented by this appeal is whether appellant received any income from the

illegal sale of controlled substances. The DEA investigation report and the report submitted by the San Diego Sheriff's Department, which contain references to appellant's actions and activities, the results of the search conducted by.the sheriff's deputies at the time of appellant's arrest, and the statements and admissions of Gus Brose, establish at least a prima facie case that appellant received unreported income from the sale of controlled substances during the appeal years.

The second issue is whether respondent properly reconstructed the amount of appellant's 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), repealed July 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. 76. 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 insure that use of the projection method 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, 324 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; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

In the instant appeal; respondent relied upon both the admission of Gus Brose that he had been purchasing narcotics from appellant since mid-summer 1977, as well as the records maintained by appellant, in reconstructing the latter's income. Specifically, respondent determined that appellant: (i) had been engaged in the "business" of selling controlled substances from at least July 1, 1977, through February 28, 1979, a period of 20 months; (ii) realized gross income of at least $211,611.90 from such sales over that period, a monthly average of $10,580, thereby resulting in gross income of $63,480 for the last six months of 1977 and $126,960 for 1978; and (iii) had a standard cost of "goods" sold equal to 50 percent of his selling price. While we believe that the statements of Brose are credible and that it was reasonable for respondent to rely upon appellant's records in order to reconstruct the amount of income he derived from the illegal sale of narcotics, we cannot unqualifiably agree with the manner of respondent's reconstruction.

Initially, we observe that the first element of respondent's reconstruction formula is based upon Brose's admission that he began purchasing cocaine from appellant in mid-summer 1977. 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); 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 Brose was unreliable. To the contrary, that record reveals that his statements to DEA agents at the time of his aforementioned arrest were completely consistent with observations made during the DEA investigation. Moreover, Brose's statement that he was indebted to appellant in 'an'amount of "about $2,400" is supported by appellant's above-described ledger which shows a $2,495 payment due from Brose.

The second element of the reconstruction formula concerns the amount of gross income appellant realized from narcotics sales during the aforementioned 20-month period. Based upon appellant's ledger, which shows entries totaling $211,611.90, respondent concluded that his average monthly gross income was $10,580. Appellant's attorney has advanced the argument that respondent has improperly relied upon his client's records because "it is possible that the ledger is mere fantasy, . . ." Given the inherently untenable nature of this argument, together with the above-discussed evidence in the record of this appeal, we find appellant's position less than persuasive, and conclude that it was reasonable for respondent to rely upon appellant's ledger as an accurate record of his sales. (See Appeal of Philip Marshak, Cal. St. Bd. of Equal., March 31, 1982; Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal., July 29, 1981.) Indeed, to the extent that respondent concluded that appellant's ledger represented his sales for the entire 20-month period, it is a conservative determination. Simply because Brose's name constitutes one of the first entries in the ledger does not lead to the conclusion that the ledger constitutes a complete record of sales from July 1, 1977. The, sales period represented by appellant's records may be substantially less than 20 months, thereby resulting in a significantly greater average monthly gross income.

The only defect we can find in respondent's reconstruction concerns its conclusion that all the

entries in appellant's ledger constituted gross income. Our review of appellant's records, and of the record of this appeal, indicates that as he collected on amounts due him from his purchasers, he crossed out the relevant entry in his ledger,, Thus, for example, the aforementioned debt owed him by Brose had not been crossed out. A review of appellant's ledger shows that his clients were indebted to him in the total amount of $15,135; since appellant had not received this money, it did not constitute gross income to him. (Cf. Rev. & Tax. Code, § 17071; see also Appeal of Edwin V. Barmach, supra.) Accordingly, we conclude that appellant's gtoss income from- the sale of controlled substances of the subject 20-month period was at least $196,476.90, an average of $9,823.84 each month. Therefore, he realized gross in-come of $58,943.04 for the six-month period in 1977, and. $117,886.08 for the year 1978. Finally, respondent's conclusion that appellant's cost of "goods" sold was equal to 50 percent of his selling price is supported by reliable law enforcement data previously utilized by this board.[1/] (Appeal of Eduardo L. and Leticia Raygoza, Cal. St. Bd. of Equal., July 29, 1981.)

T Whrle-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 deduction's 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

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 the sale of controlled substances, we must conclude that respondent's reconstruction, as modified herein, properly computed the amount of such income.

The final issue presented by this appeal concerns the propriety of respondent's imposition of a 25 pet-cent delinquency penalty assessed appellant for the year 1977. In pertinent part, Revenue and Taxation Code section 18681, subdivision (a), provides as follows:

1/ (Continued)

> 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 ilegal 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 constitutes an illegal activity as defined by chapter 6 of division 10 of the Health and Safety. Code. (Health & Saf. Code, §§ 11'350, et seq.) Accordingly, no deduction for appellant's cost of "goods" sold is allowable.

> If any taxpayer fails to make and file a return required by this part on or before the due date of the return or the due date as extended by the Franchise Tax Board, then, unless it is shown that the failure is due to reasonable cause and not due to willful neglect, 5 percent of the tax shall be added to the tax for each month or fraction thereof elapsing between the due date of the return and the date on which filed, but the total penalty shall not exceed 25 percent of the tax. ... (Emphasis added.)

The due date for appellant's 1977 return was April 15, 1978. (Rev. & Tax. Code, § 18432.) The jeopardy assessment issued appellant for the year 1977 was issued February 28, 1979; appellant had not previously filed a return for that year. Since appellant has presented no evidence of reasonable cause, we must conclude that respondent's imposition of a 25 percent delinquency penalty was proper. (Appeal of Carl H., Jr. and Madonna Gross, Cal. St. Bd. of Equal., Aug. 16, 1979; Appeal of Clyde L. and Josephine Chadwick, Cal. St. Bd. of Equal., Feb. 15, 1972.)

Based upon the above, we conclude that appellant received $62,043.04 2/ and $117,886.08 in taxable income during the years in issue, respectively. These amounts are substantially in excess of those originally computed by respondent and are sufficient to sustain the subject jeopardy-assessments in their entirety.

2/ This figure includes the $3,100 appellant acknowledges as his income from sources other than the sale of narcotics during 1977.

Appeal of Mart Conrad Wende

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 Mart Conrad Wende for reassessment of jeopardy assessments, including a penalty for the year 1977, in the total amounts of $3,238.75 and $5,962 for the years 1977 and 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of March, 1983, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Nevins and Mr. Harvey present.

_____, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code Section 7.9