

Appeal of Gregory Flores, Sr.

The issues are whether appellant received unreported income from illegal sales of narcotics and, if **so**, whether respondent properly reconstructed the amount of that income.

On or about May 15, 1980, an informant disclosed to authorities that appellant's wife, Suzanne Flores (hereinafter "Suzanne"), was dealing in narcotics. Thereafter, the Los Angeles Police Department conducted a criminal investigation of appellant and his wife. Based upon information gained in that investigation, the Los Angeles police raided appellant's residence in Wilmington, California, on May 28, 1980. When plainclothes officers announced their identities, Suzanne yelled "police" and threw a package of heroin against the wall. Appellant was apprehended as he approached a chest of drawers which was found to contain 37 balloons containing 1.16 ounces of heroin, 40 capsules containing 1.06 ounces of heroin, bags containing 2.39 ounces of heroin, and numerous papers identifying both appellant and Suzanne. Also seized at that time was \$2,701 in cash, two pounds of lactose cutting agent, a scale, and 1.44 ounces of marijuana. Further information which was noted in the police report indicated that both appellant and Suzanne had been involved in selling heroin for seven months previous to the raid. Accordingly, both were arrested at that time and charged with possession of heroin for sale.

After being informed of the arrests of appellant and **Suzanne**, respondent terminated their 1980 taxable year and issued jeopardy assessments amounting to \$7,954 for each. These assessments, based upon the available evidence, were grounded upon respondent's determination that the total income of appellant and Suzanne during the period January 1, 1980, through May 30, 1980, was **\$189,000^{1/}** or \$94,500 for each spouse. Thereafter, respondent reduced the jeopardy assessments to **\$4,011.50 each^{2/}** by allowing a 50 percent cost-of-goods sold deduction^{2/} which resulted in a net taxable income of \$47,250 for each spouse.

1/ Suzanne Flores, appellant's wife, has not appealed the assessment against her which has now become final.

2/ As explained in footnote 4, *infra*, this deduction is now statutorily prohibited.

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The initial question presented is whether appellant earned any income from heroin **sales** during 1980. Appellant appears to concede that gains from unlawful activities constitute income (United States v. Sullivan, 274 U.S. 259 [71 L.Ed. 1037] (1927)) but argues that any such income was his wife **Suzanne's** and not **his.**^{3/} He also argues that any statements implicating him in the drug sales are untrustworthy hearsay,

Appellant's arguments are not persuasive. The investigation and arrest reports, containing statements by informants, as well as corroborating observations by police officers, establish at least a prima facie case that appellant was involved in the "business" of selling heroin. While those reports are hearsay, they are nonetheless admissible evidence in a proceeding before this board. (Cal. Admin. Code, tit. 18, § 5035, subd. (c).) Those reports reveal that three confidential reliable informants had personal knowledge that both **Suzanne and** appellant were selling heroin and had been doing so for seven months prior to the raid. Plainclothes investigators observed several known heroin addicts enter and leave appellant's residence in short succession, indicating drug sale activities. During the raid of appellant's house, he was apprehended as he was approaching a chest of drawers containing large quantities of heroin. Various drug selling paraphernalia (e.g.; cutting agents, scale, balloons) were also found in appellant's residence. In addition, both appellant and **Suzanne had** served prior prison terms for heroin sales. Indeed,, at a conference with respondent, appellant admitted that he was involved with the drug-selling activities. Under these circumstances, appellant's later allegation that "the income from the heroin sales was his **wife's** and not". his is simply not credible. Moreover, in situations like the instant case, where each participant contributed vital services to the success of the venture, the taxing-authority may attribute equal shares of the income to each participant pursuant to a partnership theory. (Daniel T. Galluzzo, et al., II 81,733 P-H **Memo. T.C. (1981).**)

^{3/} While **Suzanne Flores** was convicted for possessing heroin for sale, appellant was not prosecuted due to technical legal difficulties. The fact that these charges were dropped against appellant is not controlling in these proceedings. (See Appeal of **David Leon Rose**, Cal. St. Bd. of Equal., **supra.**)

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Accordingly) we find that appellant did receive **unreported income** from the sale of heroin and that **respondent's** equal division of the income **between** him and his wife Suzanne was appropriate.

The second question is whether respondent properly reconstructed the amount of appellant's income from drug sales. The California Personal Income Tax Law requires a taxpayer to state specifically the items and amount of his gross income during the taxable year. As **indicated above**, gross income includes **gains** derived from **illegal activities**, including the illegal sale of narcotics, **which must** be reported **on** the taxpayer's return. (United States v. Sullivan, supra.) Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. § 1.44.6-1(a)(4); former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25, 1981 (Register 81, No. 26).) Appellant admits that he kept no record of drug sales. 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 4-92, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979,)

In the instant appeal, respondent used the **projection** method to reconstruct appellant's income from the illegal sale of heroin. In short, respondent projected a level of **income over** a period of time. Because of the 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 326 (5th Cir. 1966); Appeal of Burr McFarland 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

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'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 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, 424 U.S. 614 [47 L.Ed.2d 2781 (1976); Appeal of Burr McFarland 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 McFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

In this appeal, the **evidence** relied upon by respondent in reconstructing **appellant's** income was derived from the results of the Los Angeles Police Department investigation and raid. Specifically, respondent determined that: (1) appellant had been in **the "business"** of selling heroin from at least **January 1, 1980**, through **May 28, 1980**; (2) appellant sold **heroin for \$1,800** an ounce; and (3) appellant sold five ounces of heroin per week during the period under appeal. **Accordingly**, respondent concluded that appellant and **Suzanne** realized a gross income of **\$189,000⁴** during the period under appeal half of which (i.e., \$94,500) was attributed to each person. As indicated above, after allowance of **a 50-percent** cost of goods sold deduction, a net taxable income of \$47,250 was attributed to each spouse.

4/ Pursuant to Revenue and Taxation Code section 17297.5, effective September 14, 1982, to be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise, no deduction for the cost of "goods" sold from illegal sales of controlled substances is allowed. (See Appeals of Manuel Lopez and Miriam Chaidez, Cal. St. Bd. of Equal., Jan. 3, 1983.) Accordingly, appellant's allegation relating to his high cost of goods is not relevant to this proceeding.

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The record indicates that respondent's reconstruction of appellant's income is reasonable, being based upon credible evidence and not conjecture. First, reliable information contained in the police reports indicates that appellant had been selling heroin for seven months prior to his arrest. Moreover, appellant had a previous history of selling heroin, and he possessed drug-selling paraphernalia at the time of his arrest. Based on these facts, respondent's determination that appellant engaged in heroin sales from January 1, 1980, through May 28, 1980, or five months, appears to be reasonable. Secondly, appellant concedes that the heroin was sold for \$1,800 an ounce, apparently, its contemporaneous street value. Thirdly, respondent's determination of the weekly volume of drug sales also appears, to be reasonable. We have noted before that because of the risks inherent in the illegal drug business, it is "reasonable to assume that a dealer would only have the amount of drugs which could be easily and quickly disposed of." (Appeal of Clarence P. Gonder, Cal. St. Bd. of Equal., May 15, 1974.) We have previously found an inventory turnover rate of once a week to be reasonable. At the time of their arrest, appellant and Suzanne were in possession of approximately five ounces of heroin, and respondent determined this amount to be appellant's weekly volume of drug sales. As indicated above, this determination also appears to be reasonable.

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Based on the above, and in view of the provisions of Revenue and Taxation Code section 17297.5 (which would serve to increase the assessment substantially), we conclude that appellant received a total of \$94,500 in unreported taxable income from the illegal sale of heroin during the appeal period. This 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** on the petition of Gregory Flores, Sr. for **reassessment** of a personal income tax jeopardy **assessment** in the amount of **\$4,011.50** for the period January **1, 1980**, to May **30, 1980**, be and the same **is** hereby sustained.

Done at Sacramento, California, this **1st** day of August, **1984**, by the State **Board of Equalization**, with Board members **Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett** and **Mr. Harvey** present.

<u>Richard Nevins</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Conway H. Collis</u>	, Member
<u>William II. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9