BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
STEPHEN BELLAMY)

For Appellant: Victor Sherman
Attorney at Law

For Respondent: Michael E. Brownell
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 Stephen Bellamy for reassessment of a jeopardy assessment of personal income tax in the amount of $6,178 plus a fraud penalty in the amount of $308.90 for the period January 1, 1979, through May 18, 1979.

Appeal of Stephen Bellamy

The primary issues for determination are the following: (i) did appellant receive unreported income from illegal drug activities during the appeal period; (ii) if he did, did respondent properly reconstruct the amount of that income; and (iii) whether respondent properly assessed a fraud penalty against appellant pursuant to Revenue and Taxation Code section 18685.

On May 17, 1979, agents for the Drug Enforcement Administration (hereinafter "DEA") made arrangements for a confidential informant to meet with one [redacted] for the purpose of purchasing some 12 kilograms of cocaine. That informant indicated that [redacted] was interested in such a transaction, but first had to meet with a person named "Steve" in order to work out the details. In a later meeting with the confidential informant, [redacted] indicated that he had met with "Steve" and that he and "Steve" would be willing to meet the informant and his partner (an undercover DEA agent) to consummate the sale. On May 18, 1979, after DEA agents showed $170,000 in cash to him, [redacted] placed a telephone call. Thereafter, [redacted] took a taxi to a hotel where he was seen entering one of the hotel rooms. Shortly after, appellant Stephen Bellamy was seen entering the same hotel room. At 5:30 p.m. on May 18, 1979, after approximately 17 kilograms of cocaine were transferred in an adjacent parking lot, the DEA agent gave a prearranged signal to other agents on surveillance and [redacted] and appellant were placed under arrest.

After his arrest, [redacted] agreed to cooperate with the government. DEA reports indicated that he had received four kilograms of cocaine from appellant in January or February of 1979. He indicated that he had delivered money to appellant's home at least ten times and that he had picked up cocaine at appellant's house on two or three occasions. On one occasion, he delivered $250,000 to appellant's home. Moreover, [redacted] noted that about one week before his arrest, appellant had delivered about five kilograms of cocaine for him to sell. When his efforts to sell all five kilograms proved unsuccessful, appellant took back four kilograms stating that he knew someone else who could sell that quantity right away. [redacted] also reported that appellant's source of cocaine was one Nick Hunter, who apparently was a large-scale drug dealer. [redacted] stated that appellant had told him that Hunter transported large quantities of cocaine from Miami to Los Angeles by private plane and possessed an inventory of some 700 kilograms of cocaine. Appellant also told [redacted] about a one-week

trip that he and his wife had taken with Hunter to the Grand Cayman Islands in March of 1979 entirely at Hunter's expense.

While appellant was 'less cooperative with the government, the DEA report of his interview was quite revealing. Appellant, who had the benefit of legal counsel, stated that he had known Hunter for nine to ten years prior to his arrest and that he had been associated with Hunter's cocaine operations for approximately three years. Appellant added that Hunter was distributing 100 to 200 kilograms of cocaine every other month and that he himself had seen approximately 100 kilograms of cocaine at one time. Appellant exhibited a detailed and extensive knowledge of Hunter's drug operations. He confirmed that he and his wife had accompanied Hunter to the Grand Cayman Islands where Hunter deposited several million dollars in local banks.

On July 30, 1979, appellant entered a plea of guilty to an indictment charging him with distributing 26 pounds or approximately 13 kilograms (approximately three-fourths of the amount to be transferred at the time of appellant's apprehension) of cocaine in violation of subsection (a)(1) of section 841 of title 21 of the United States Code.' In the prosecution's memorandum of information for sentencing,.. the government contended that appellant was Hunter's principal confidant in Hunter's Los Angeles area cocaine distribution ring. Appellant, the government noted, had been trusted with the above-noted cocaine having a wholesale value of approximately $700,000 and a street value of over $2,000,000. With appellant's involvement in money transportation and cocaine distribution on such a grand scale and his ability to contact Hunter directly, the memorandum concluded that appellant was Hunter's trusted lieutenant. Appellant was sentenced to prison for a period of seven years.

On May 18, 1979, respondent was notified of appellant's arrest. Concluding that the cocaine seized at the time of his arrest had a total value of $564,000 and that his share of that sum was 75 percent, or $423,000, respondent issued a jeopardy assessment of $45,584 for appellant's 1979 taxable year. Later, respondent learned that appellant had not himself purchased the cocaine which had been seized, but instead that the cocaine belonged to Hunter. Relying upon appellant's attorney's statement that appellant was to receive $18,000 for the distribution of the 12 kilograms of cocaine, respondent

concluded that appellant was to receive $1,500 per kilo-. gram distributed. Respondent then projected that appellant, who was to distribute 12 kilograms in the sale which resulted in his arrest, distributed 12 kilograms per month for the four previous months. This projection resulted in revising appellant's taxable income from cocaine sales to $72,000 for that period and a notice of action was issued reducing the previously issued jeopardy assessment to $6,178 in tax plus a $308.90 fraud penalty pursuant to Revenue and Taxation Code section 18685.

Appellant filed a petition with respondent for reassessment contending that he was merely a delivery boy for the one transaction that led to his arrest and that, accordingly, he did not receive any income from drug sales during the period at issue. Respondent affirmed the assessment and appellant's protest led to this appeal.

The initial question presented by this appeal is whether appellant received any income from the sale of cocaine during the period at issue. Respondent may adequately carry its burden of proof through a prima facie showing of illegal activity by the taxpayer. (Hall v. Franchise Tax Board, 244 Cal.App.2d 843 [53 Cal.Rptr. 597] (1966); Appeal of [redacted] Hummel, Cal. St. Bd. of Equal., March 8, 1976.) In Appeal of Bruce James Wilkins, decided by this board on May 4, 1983, we held that the Franchise Tax Board had established such a prima facie case based upon information obtained from the police reports involving criminal investigation. We are likewise satisfied in the instant appeal upon review of the extensive record that appellant received unreported income from cocaine sales during the appeal period. Briefly, the record establishes that appellant was a close and longtime friend of Nick Hunter, an admitted large-scale cocaine dealer. Appellant and his wife accompanied Hunter to the Grand Cayman Islands in March of 1979 at which time Hunter deposited several million dollars in local banks. DEA reports indicate that appellant had helped to distribute significant amounts of cocaine to [redacted] on at least three occasions prior to his arrest, one of which was in 1979. In addition, [redacted] stated that appellant had other avenues for distributing cocaine obtained from Hunter in 1979. Moreover, the DEA report contained in the record indicates that appellant himself admitted that he had been associated with Hunter's cocaine distribution operations for three years prior to his arrest. Based upon the above, the conclusion is inescapable that respondent

has established a prima facie case that appellant received income from cocaine sales during the period at issue.

The second issue presented is whether respondent properly reconstructed the amount of appellant's income from cocaine-selling activities during the period at issue. The California Personal Income Tax Law requires that a taxpayer state specifically the items and amount of his gross income during the taxable year. Gross income includes all income from whatever source derived unless otherwise provided in the law. (Rev. & Tax. Code, § 17071.) 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, 274 U.S. 259 [71 L.Ed. 1037] (1927); 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 (Register 81, No. 26).) 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.)

As indicated above, respondent used the projection method to reconstruct appellant's income from the sale of cocaine. 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), aff'd. 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 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 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. Dono, 428 F.2d 204 (id Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr MacFarland Lyons, supra; Appel 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 reports of the DEA investigation, including statements given by appellant together with admissions made by appellant and/or his attorney in the criminal proceeding. Specifically, respondent determined that: (i) appellan't had been in the business of selling cocaine for the four months prior to his arrest in May of 1979, or from January through April of 1979; (ii) appellant sold 12 kilograms of cocaine per month during the four-month period; (iii) <appellant received $1,500 per kilogram of cocaine which he sold; and (iv) appellant realized gross income of $72,000 from the sale of cocaine during the period under appeal.

We believe appellant's statements to investigators regarding his cocaine operations to be true. Those statements, together with the other evidence obtained 'froin 'the DEA investigation, support the reasonablenessof each of the elements of respondent's formula. (See Appeals of Alfred 'M. Salaas and Betty Lee Reyes, Cal. St. Bd. of 'Equal., Feb.,8 1984,) As indicated above, appellant admitted that he was involved with the Hunter cocaine distribution operations for three years prior to his arrest and that this period encompassed the entire

period of time under appeal. Evidence exists that in 1979 appellant placed at least one delivery of cocaine with [redacted] prior to his arrest and at least one other delivery with another contact. Moreover, given the high volume of cocaine handled by the Hunter organization (100 to 200 kilograms of cocaine every other month) and his close relationship with Hunter (friend for ten years; guest at the Grand Cayman Islands), sales of some 48 kilograms of cocaine (or 12 kilograms per month) by appellant during the period under review appear to be reasonable. Next, admissions by appellant's attorney indicate that appellant received $1,500 per kilogram of cocaine which he sold. Since respondent may properly determine that a single member of a group engaged in a criminal activity producing income can be charged with the entire income, respondent's acceptance of appellant's remuneration per kilogram sold at $1,500 appears to be generously reasonable. (Ronald L. Miller, ¶ 81,249 P-H Memo. T.C. (1981); Appeals of Alfred M. Salas and Betty Lee Reyes, supra.) Accordingly, the estimate of appellant's gross income from the sale of cocaine during the period at issue appears reasonable. 1/

Notwithstanding the above analysis, appellant argues that ,the requisite "credible evidence" is not present in this matter. Appellant argues that the information (DEA reports) upon which respondent relies is based upon hearsay statements and should, accordingly, be disregarded here. However, we have previously found such documents to be "credible evidence." (See e.g., Appeals of Manuel Lopez and Miriam Chaidez, Cal. St. Bd. of Equal., Jan. 3, 1983; Appeal of Bernie Solis, Jr., and Lucy Solis, Cal. St. Bd, of Equal., June 23, 1981.) In addition, we have held that the technical rules of evidence do not preclude our consideration of the entire record for purposes of deciding these appeals. (Appeal of Marcel C. Robles, supra.) While these reports are hearsay, they are nonetheless admissible evidence in a proceeding before this board. (Appeal of David Leon Rose, supra; see also Cal. Admin. Code, tit. 18, § 5035, subd. (c).)

1/ Since respondent has introduced substantial evidence which indicates that its projections are reasonable, this is not one of the rare cases where the assessment can be found to be arbitrary. (Cf. Leonard Jackson, 73 T.C. 394 (1979); Weimerskirch v. Commissioner, 596 F.2d 358 (9th Cir. 1979).)

Appellant further contends that while this action was pending, on May 24, 1983, respondent improperly issued a second assessment in excess of $11,080 for the period at issue. We note, however, that appellant did not timely appeal the second assessment to this board and that we do not now have jurisdiction to consider its propriety. We note further that our decision here likewise cannot uphold the second assessment.

As indicated above, a fraud penalty was also imposed against appellant pursuant to section 18685 of the Revenue end Taxation Code,[2/] The burden of proving fraud is upon respondent, and it must be established by clear and convincing evidence. (Appeal of George W. Fairchild, Cal. St. Bd. of Equal., Oct. 27, 1971.) Fraud implies bad faith, intentional wrongdoing, and a sinister motive; the taxpayer must have the specific intent to evade a tax believed to be owing. (Appeal of Barbara P. Hutchinson, Cal. St. Bd. of Equal., June 29, 1982.) We have held that conviction of grand theft is not such clear and convincing proof of tax fraud. What is needed for respondent to carry its burden of proof is evidence of affirmative acts of concealment, misrepresentation or subterfuge on the part of appellant. (Appeal of Hubbard D. and Cleo M. Wickman, Cal. St. Bd. of Equal., Feb. 2, 1981.) Respondent produced no such evidence in this appeal. In fact, respondent has not even addressed the penalty issue. Accordingly, based upon the record before us, respondent's action with respect to the fraud penalty must be reversed.

2/ The record indicates that a "fraud" penalty was assessed pursuant to section 18685 of the Revenue and Taxation Code. However, the section 18685 fraud penalty is fifty percent; the penalty assessed in this appeal was only five percent. Perhaps respondent intended: to assess the five-percent negligence penalty pursuant to section 18684 of the Revenue and Taxation Code.

Appeal of Stephen Bellamy

O.RD 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 Stephen Bellamy.for reassessment of a jeopardy assessment of personal income tax in the amount of $6,178 plus a fraud penalty in the amount of $308.90 for the period January 1, 1979, through May 18, 1979, be and the same is hereby reversed with respect to the fraud penalty. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 8th day of January , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Richard Nevins , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9