BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CLARENCE P. GONDER)

For Appellant: Judd C. Iversen
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Marvin J. Halpern
Counsel

OPINION

This appeal is made pursuant to sections 18646 and 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Clarence P. Gonder for reassessment of a jeopardy assessment of personal income tax in the amount of $3,675 for the period January 1 through June 29, 1971.

Appellant was arrested on June 11, 1971, and charged with sale of heroin, possession of marijuana for sale, and possession of

dangerous drugs for sale. On June 29, 1971, appellant was arrested again and charged with possession of narcotics for sale. At the time of the second arrest, $3,608 was seized from the safe in appellant's antique store. Appellant eventually pled guilty to violation of section 11501 of the California Health and Safety Code, which prohibits the sale of heroin, and was sentenced to state prison.

Respondent was notified of appellant's arrest and determined that surrounding circumstances indicated that collection of appellant's personal income tax for the period in question would be jeopardized by delay. Accordingly, a jeopardy assessment in the amount of $3,675 was issued on July 8, 1971, terminating appellant's taxable period as of June 29, 1971. In issuing the jeopardy assessment, respondent found it necessary to estimate appellant's income for the period. In utilizing the available evidence before it, respondent determined that appellant's taxable income was $44,200. The tax liability of $3,700 on this amount, when reduced by the $25 personal exemption credit, produced a net tax liability of $3,675. Pursuant to section 18817 of the Revenue and Taxation Code, respondent obtained from the California Bureau of Narcotic Enforcement the $3,608 seized from appellant. on June 29, A petition for reassessment was filed by appellant and subsequently denied. The propriety of the assessment is the sole issue raised by this appeal.

In order to properly consider this issue, the events leading up to appellant's arrest and the subsequent jeopardy assessment are related below.

During May 1971, the California Bureau of Narcotic Enforcement (hereinafter referred to as the Bureau), in cooperation with the Alameda and Oakland Police Departments, developed information that appellant had been trafficking in major quantities of narcotics for some time. On May 25, an undercover agent from the Bureau met appellant in Oakland and purchased approximately three ounces of heroin from him for $900 in marked money. At the same time arrangements were made by the agent to purchase an additional one pound of heroin from appellant for $10,400.

On June 11, the Bureau agent met with appellant, intending to consummate the purchase of the one pound quantity of heroin. However, appellant was either unable or unwilling to conclude the

sale, maintaining that he did not have the necessary cash to finance such a large purchase. Appellant later stated that he had no source for acquiring such a large amount of heroin. In any event, when appellant refused to conclude the sale the agent gave a signal and appellant was arrested by other agents.

Immediately thereafter, pursuant to a search warrant, appellant's business premises were searched. The search revealed the following: (1) one plastic bag containing amphetamine tablets with a gross weight of 59.0 grams: (2) one metal box containing four sealed envelopes, each containing secobarbital, with a gross weight of 109.0 grams: (3) twenty-three plastic bags containing phencyclidine on vegetable matter with a gross weight of 52.1 grams; (4) fifteen plastic bags, each containing marijuana, with a gross weight of 246.0 grams; (5) one can labeled "Lactose Merck" containing a white powder; (6) one bottle containing a cutting agent: and (7) paraphernalia used for the processing of narcotics for sale. A total of $1,23 6 was found on appellant at the time of his arrest.

On June 29, another search warrant was obtained for appellant's place of business, at which time over 80 grams of cocaine were found, with a street value of approximately $3,000. A total of $3,608 was seized from appellant at the time of this arrest.

On February 17, 1972, respondent received income tax returns executed by appellant for the entire 1971 taxable year and for the taxable period January 1 through June 29, 1971. These returns failed to report income from sales of narcotics and did not indicate that appellant was engaged in this occupation.

After considering the available evidence, respondent determined that appellant had failed to provide the necessary information from which an accurate statement of income, including income from his sales of narcotics, could be prepared. Therefore, respondent concluded that it was necessary to reconstruct appellant's income.

The first method[1] utilized by respondent in reconstructing appellant's income was based on the $3000 worth of cocaine seized on June 29, the time of appellant's second arrest. This inventory was in addition to the substantial quantities of narcotics-; marijuana, and dangerous drugs seized on June 11. In view of appellant' s failure to supply requested information, respondent was required to estimate the speed with which appellant was able to sell the quantity of drugs seized. Respondent determined that, based on the risks inherent in the illegal drug business, it was reasonable to assume that a dealer would only have on hand the amount of drugs which could be easily and quickly disposed of. Therefore, since $3,000 worth of cocaine was seized on June 29, respondent adopted an inventory turnover rate of once a week and reconstructed appellant's income as follows: $3,000 worth of cocaine seized, times 26 weekly sales, equals $78,000 in total sales. Respondent pointed out that if the additional large quantities of amphetamines, secobarbital, and marijuana, which were seized on June 11, were considered, their values would substantially increase the $78,000 total sales figure. It may also be noted that respondent's reconstruction did not consider the actual sale of three ounces of heroin to the Bureau agent for $900. Respondent submits that although a much larger estimate of appellant's income could have been reconstructed its estimate of $44,200 was reasonable.

Basically, appellant challenges the assessment as being arbitrary and without any factual basis. Appellant asserts that there is no evidence to support the contention that he made $44,200 during the 26 week assessment period.

We do not find the arguments advanced by appellant to be persuasive. In the Appeal of John and Codelle Perez, decided

1/ Respondent also suggested a second method of reconstructing appellant's income, which involved not only the actual sale of three ounces of heroin to the Bureau agent for $900, but also the anticipated sale of one pound of heroin for $10,400. However, since the anticipated sale was not completed and no such large quantity of heroin, nor the means to acquire it, were attributed to appellant, we find this method unconvincing. However, the defects in this method of reconstruction do not infect the method discussed above.

adversely to the appellants by this board Feb. 16, 1971, the facts and the basic issues were in all material respects identical to those presented here. (See also, Appeal of Walter L. Johnson, Cal. St. Bd. of Equal., Sept. 17, 1973.) Accordingly, we find that Perez controls the instant appeal and set out our reasoning below,

The California Personal Income Tax Law requires a taxpayer to state specifically the items 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]; Farina v. McMahon, 2 Am. Fed. Tax R. 2d 5918.)

Every taxpayer is required to maintain accounting records that will enable him to file an accurate return. (Cal. Admin. Code, tit. 18, reg. 175 61, subd. (a) (4).) In the absence of such records the Franchise Tax Board is authorized to compute income by whatever method will, in its opinion, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b); Breland v. United States, 323 F.2d 492; Harold E. Harbin , 40 T. C . 373; Appeal of John and Codelle Perez, supra.)

The determination of a deficiency by the taxing authority is presumed correct, and the burden is on the taxpayer to prove that the correct income was an amount less than that on which the deficiency assessment was based. (Kenny v. Commissioner, 111 F. 2d 374; Appeal of John and Codelle Perez, supra.) No particular method of reconstructing income is required, since the circumstances will vary in individual cases. (Harold E. Harbin, supra.) The existence and amount of unreported income may be demonstrated by any practical method of proof that is available. (See, e. g. , Davis v. United States, 226 F.2d 331; Asnellino v. Commissioner, 302 F.2d 797; Isaac T. Mitchell, T. C. Memo., June 27, 1968, aff'd, 416 F.2d 101; Appeal of John and Codelle Perez, supra; Appeal of Walter L. Johnson, supra.)

While appellant does not contest the principles announced above, he does challenge respondent's method of reconstructing income on several grounds. First, appellant argues that respondent erred in

estimating appellant's income for six months without any indication of how extensively, or for what period of time, appellant had been engaged in the sale of narcotics. However, on two separate occasions within eighteen days, large quantities of narcotics, marijuana, and dangerous drugs, all of which were packaged for sale, were seized at appellant's place of business. This is sufficient to indicate that appellant was dealing extensively in the illicit drug business. Furthermore, there was additional information contained in the probation report which indicated that respondent's determination that appellant was trafficking in drugs for a six-month period was a conservative one. Under the circumstances, we cannot say that the six-month period selected by respondent was unreasonable. (Isaac T. Mitchell, supra; Appeal of John and Codelle Perez, supra; Anneal of Walter L. Johnson, supra.)

Next, appellant apparently maintains that he should be allowed to deduct his expenses incurred in acquiring the narcotics for sale. Initially, it is noted that appellant offered no evidence as to the amount of his cost or basis in the contraband. In any event, it does not appear that any deduction of costs would be in order. The deduction of expenses incurred in an illegal business may be disallowed if the payments for which the deduction is claimed were in violation of public policy. (Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 [2 L. Ed. 2d 562]; see also, Finley v. Commissioner, 255 F.2d 128; Lorraine Corp., 33 B.T.A. 1158.) This rule has been applied with respect to illegal sales of narcotics. (Appeal of John and Codelle Perez, supra.)

Appellant makes several other assertions in an attempt to undermine respondent's reconstruction of income for the period in question. We do not find them persuasive. Again, we emphasize the fact that, when the taxpayer fails to comply with the law in supplying the required information to accurately compute 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 the reasonable reconstruction of income will be presumed correct and the taxpayer has the burden of disproving such computation even though crude. (Agnellino v. Commissioner, supra; Merritt v. Commissioner, 301 F. 2d 484.) Mere assertions by the taxpayer are not enough to overcome that presumption. (Pinder v. United States, 330 F. 2d 119.)

Appeal of Clarence P. Gonder

After reviewing the entire record we find no basis for reversing the action taken by respondent.

ORDER

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 P. Gonder for reassessment of a jeopardy assessment of personal income tax in the amount of $3,675 for the period January 1 through June 29, 1971, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of May, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary