BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DAVID LEON ROSE)

For Appellant: Cohen, Stokke, Owen & Davis
Attorneys at Law

For Respondent: Bruce W. Walker
Chief Counsel

Jack E. Gordon
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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 David Leon Rose for reassessment of a jeopardy assessment of personal income tax in the amount of $4,455 for the year 1972.

Appeal of David Leon Rose

We must decide whether appellant received unreported income from illegal sales of narcotics and, if he did, whether respondent properly reconstructed the amount of that income.

Appellant David Leon Rose was employed as an insurance agent during the period in question. Early in 1973 he was arrested and charged with illegal narcotics sales. Nanci Ulrich, who had worked for the same insurance agency as appellant since late August or early September 1972, was also arrested on similar charges about that time. The following summary of the facts is taken largely from the investigation and arrest reports of appellant and Ulrich, compiled by agents of the California Bureau of Narcotic Enforcement (hereinafter "BNE").

BNE was alerted by an informant on November 30, 1972, that Ulrich and one France Michael Canady, Jr. , were selling large quantities of cocaine in the area of Garden Grove, California. That same day BNE undercover agents contacted Ulrich and arranged to purchase one-quarter ounce of the drug. Ulrich reported that she would be able to secure additional multiple ounces without trouble. Later that night the agents met with Canady, who transferred the cocaine to them in exchange for $400 in recorded state funds. **Canady related that the quarter-ounce** sold to the agents.came from a four pound lot.

The following day, December 1, 1972, BNE agents contacted Ulrich and inquired about purchasing a full ounce of cocaine. Ulrich said that "Dave" would "front" her the cocaine, but that delivery might be delayed because "Dave got ripped off for 30 grand last night. .. The people that Dave was scoring from ripped him off and he's taking care of them now. " She also stated that although those people were not Dave's only connection, "it will take him a while to get it together. " Ulrich added that she and Dave worked at the same place, and that "Dave's a straight-looking businessman. You would never know he was a dealer. "

On December 5, 1972, three BNE undercover agents met with Ulrich and Canady to complete the sale. Ulrich told the agents that "D. R." would phone to tell her where to pick up the cocaine, and after receiving a call, she directed the agents to a phone booth near a local restaurant where they were to wait for further instructions.

Canady then led the agents to the phone booth. One agent waited in the booth, while the other two agents accompanied Canady into the restaurant, After a while Canady left the restaurant and was seen speaking to a man later identified as appellant. Canady then returned to the restaurant and told the agents "The telephone must be broken. Dave told me it keeps ringing and your man doesn't answer the phone. He told me the ounce is at the bottom of that light pole. ..." The agents picked up the cocaine, gave Canady $1,400 in recorded state funds, and left the area. A short time later another BNE agent observed appellant enter the restaurant and confer with Canady.

BNE agents contacted Ulrich again on December 8, 1972, concerning the possible purchase of a second ounce of cocaine . Ulrich indicated that. there might be a slight delay because of concurrent negotiations for the sale of 10 ounces of cocaine to another buyer, but later that day she confirmed that the sale could be made. The agents then inquired about buying a full pound of cocaine, and the following dialogue ensued.

Ulrich: Fantastic1 We do a pound a quarter at a time. He won't handle that much coke at one time. We do it all in one day. We'll meet you at 10:00 o'clock and do a quarter, then at 12:00 o'clock, 2:00 o'clock and 4:00 o'clock.

Agent: What's the price on a pound?

Ulrich: Ten fifty a Z.

Agent: This guy Rose is a pretty shrewd character.

Ulrich: He' s a good man.

Agent: How long have you been doing business with him?

Ulrich: Ever since I met him.

Agent: Three to four months, then?

Ulrich: Yeah.. ..

That afternoon BNE agents met with Ulrich at a restaurant to await delivery of the second ounce of cocaine, Ulrich said "Rose" should be there in 35 or 40 minutes. About two hours later appellant was seen driving into the restaurant parking Jot, and Ulrich exclaimed "Here's Rose now!" Appellant left his car and entered a Pontiac stationwagon parked nearby, but after about thirty seconds he returned to his own car and drove away. Ulrich then told the agents "It's in the glove compartment of the stationwagon." The agents retrieved the cocaine from the stationwagon and paid Ulrich $1, 200 in recorded state funds.

On December 22, 1972, BNE agents complained to Ulrich about the poor quality of the second ounce of cocaine. Ulrich apologized, saying "I'm sorry we gave you such a burn on that last Z. We didn't know how bad it was ourself until later. Rose scored the coke in L. A. and brought it right to you guys." To compensate for the inferior cocaine, she continued, "Rose said we'd sell you a Z that's almost pure for only a thousand dollars." The agents again questioned Ulrich about the price of a full pound of cocaine. Ulrich telephoned "Dave" to establish the price, but reported to the agents that he could not set the price for a full pound because he did not know what his suppliers in Los Angeles would charge.

As a result of these investigations, BNE agents concluded that appellant, along with Ulrich and Canady, was engaged in the illegal sale of cocaine. The agents estimated that the trio's sales averaged about $3,000 per week. Appellant was arrested on February 1.5, 1973, and charged with violations of former section 11501 of the Health and Safety Code (sale of narcotics). No cocaine was found in appellant's possession at the time of his arrest. Subsequently, appellant apparently pled guilty to being an accessory to the possession of a controlled substance in violation of Penal Code section 32 and former section 11500 of the Health and Safety Code, and the charge of illegal sales was dropped.

Respondent was notified of appellant's arrest on February 16, 1 973. That same day it estimated that appellant had received $52,000 in taxable income from drug sales during 1972. This figure was apparently arrived at by assuming that appellant's share of the gross receipts from drug sales averaged

$1,000 per week, and assuming further that appellant had engaged in the drug "business" continuously throughout 1972. No deductions or exclusions were allowed from gross receipts in computing taxable income. Respondent also determined that collection of the tax would be jeopardized by delay, and immediately issued the jeopardy assessment in question.

Appellant and his wife subsequently filed a timely joint California personal income tax return for 1972. No income from narcotics sales was reported. Appellant also filed a petition for reassessment of the jeopardy assessment, and respondent thereupon requested that he furnish records or other information that would allow an accurate computation of his income from drug sales. When appellant failed to do so respondent denied the petition for reassessment, and this appeal followed. Appellant does not contest the finding of jeopardy, but argues that the proposed assessment itself is arbitrary and without foundation.

The initial question presented is whether appellant **earned any income from drug sales during 1972. Appellant-concedes** that gains from unlawful activities constitute income (United States v. Sullivan, 274 U. S. 259 [71 L. Ed. 1037]; James v. United States, 366 U. S. 213[6 L. Ed. 2d 246]), but argues that there is no factual basis for a conclusion that he shared in the proceeds of the drug sales. In support of this position, he points out that nowhere in the BNE investigation and arrest reports is it established that he actually received any of the state funds given to Ulrich and Canady . He also argues that Ulrich's statements implicating him in the drug sales are untrustworthy hearsay.

Appellant's arguments are not persuasive. The investigation and arrest reports, containing Ulrich's statements as well as corroborating observations by the BNE agents, establish at least a prima facie case that appellant was engaged in the "business" of selling cocaine. While those reports are hearsay, they are nonetheless admissible evidence in a proceeding before this board. (Cal. Admin. Code, tit. 18, § 5035, subd. (c).) Moreover, the reports reveal that appellant was in fact the central figure behind the sales operation. It was appellant who procured the cocaine from various suppliers, established the selling prices, and masterminded the elaborate schemes **for**

delivering the cocaine to his customers. Appellant has not attempted to explain or rebut the BNE reports. Under these circumstances, appellant's claim that he did not -share in the profits of the sales ring is simply not credible.

The second question is whether respondent properly reconstructed the amount of appellant's income from drug sales. On this point, we note that both the state and federal income tax regulations require each taxpayer to maintain such accounting records as will enable him to file a correct return. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4); Treas. Reg. § 1. 446-1(a)(4).) In the absence of such records, the taxing agency is authorized to compute the taxpayer's income by whatever method will, in its opinion, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b); Int. Rev. Code of 1954, § 446(b)). Mathematical exactness is not required. (Harold E. Harbin, 40 T. C. 373, 377.) Moreover, a reasonable reconstruction of income is presumed correct, and the burden is on the taxpayer to disprove the computation. (Breland v. United States, 323 F. 2d 492, 496.) The presumption is rebutted, however, where the reconstruction is shown to be arbitrary and excessive or based on assumptions which find no support in the record, (Andrews v. Commissioner, 135 F. 2d 314, 318, cert. denied, 320 U.S. 748 [88 L. Ed. 444]; Thomas v. Commissioner, 223 F. 2d 83, 88: Polizzi v. Commissioner, 265 F. 2d 498, 502; Shades Ridge Holding Co. , Inc. , T. C. Memo. , Oct. 21, 1964, aff'd sub. nom. Fiorella v. Commissioner, 361 F. 2d 326.) In such a case, the reviewing authority may revise the computation on the basis of all the available evidence without regard to the presumption of correctness. (Isaac T. Mitchell, T. C. Memo. , June 27, 1968, aff'd, 416 F. 2d 101, cert. denied, 396 U. S. 1060 [24 L. Ed. 2d 754]; Shades Ridge Holding Co., Inc., supra.)

Appellant has submitted a copy of a financial statement indicating that any increase in his net worth during 1972 resulted from his earnings as an insurance agent. The statement is not dated, and includes no receipts from drug, sales. Appellant argues that respondent's reconstruction of his income is arbitrary and capricious because it is not consistent with his own net worth analysis. We disagree. Since appellant's financial statement does not account for his receipts from drug sales, it is not an accurate

reconstruction of his income. In any event, respondent is not bound to use the net worth method to compute a taxpayer's income, but may resort to any method which it believes will clearly reflect income. (Harold E. Harbin, supra, 40 T. C. at 377-378.)

Appellant also objects that respondent's reconstruction is arbitrary because it was not based on any recognized method. As indicated above, respondent computed appellant's income from drug sales by projecting his estimated average weekly receipts over an estimated period of sales activity. Use of this method in appropriate cases has been approved by both the federal courts and this board. (See, e.g., Shades Ridge Holding Co., Inc., supra; Appeal of Walter L. Johnson, Cal. St. Bd. of Equal., Sept. 17, 1973; Appeal of Clarence P. Conder, Cal. St. Bd. of Equal. , May 15, 1974; but cf. Pizzarello v. United States, 408 F. 2d 579, cert. denied, 396 U. S. 986 [24 L. Ed. 2d 450], and Lucia v. United States, 474 F. 2d 565.) Accordingly, we cannot say that use of this method is arbitrary as a matter of law. As will become clear below, however, some of the assumptions which underlie respondent's computations in this case are arbitrary and without factual foundation, and we have therefore concluded that its assessment is excessive and must be modified.

In computing appellant's taxable income, respondent assumed that he had been engaged in drug sales throughout the entire year 1972. Ulrich's admission that she and appellant had been "doing business" together for three or four months prior to December 1972, coupled with the fact that they had worked in the same insurance office since late August or early September of that year, is some evidence that appellant had been selling drugs since the first week of September. Respondent's assumption that he had sold drugs prior to that time is based on the allegedly large quantities of cocaine which he purchased and resold in December. We are not persuaded, however, that the volume of appellant's operation in December 1972 is sufficient indication, by itself, that he had been in "business" during the first eight months of that year. In fact, there is no evidence whatsoever in the record to implicate appellant in any drug sales prior to the first week of September. To the extent that respondent's assessment includes income allegedly received prior to that time, therefore, it is without foundation and excessive. (Pizzarello v. United States, supra, 408 F. 2d at 583-584; Lucia v. United States, supra, 474 F. 2d at 573-575; Shades Ridge Holding Co. , Inc., supra.)

Respondent relies on Isaac T. Mitchell, supra, Schira v. Commissioner, 240 F. 2d 672, the Appeal of Clarence P. Gonder, supra, and the Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971, to justify its assumption. None of these cases supports its position. In Mitchell, Schira and Gonder, there were admissions or other evidence sufficient to warrant a conclusion that the taxpayer had been engaged in the income-producing activity in question throughout the projection period. In Perez, the principal issue was whether the taxpayer's gross receipts from drug sales during a 49 day period could properly be considered representative of his gross receipts over a longer time, and the question of whether the evidence would justify a conclusion of continuous sales throughout the assessment period was not raised. Therefore, Perez cannot be read as approving an estimated period of sales activity which is based purely on conjecture. (See Pizzarello v. United States, supra, 408 F. 2d at 583.)

Respondent also argues that even if the estimated period of sales activity is shortened to four months, an alternative method of computing appellant's taxable income from drug sales may be used to arrive at the approximate amount of the proposed assessment. There are 122 days in the period beginning September 1, 1972, and ending December 31, 1972. On December 5 and December 8 undercover agents paid $1, 400 and $1, 200, respectively, for cocaine delivered by appellant, or an average of $1,300 each day. Assuming that the trio made one sale of approximately this size each day, respondent argues, they would have grossed $158,600 during the 122 day period. If the proceeds were divided equally among the t hrec members, appellant's share would be $52,866. The assumptions underlying this calculation, however, are patently arbitrary. BNE agents had the trio under close surveillance during the month of December. Those agents, who were in a position to know, estimated that the trio's sales averaged $3,000 per week. It is therefore unreasonable to assume, without additional evidence, that the trio averaged $1, 300 per day.

It remains only to reconstruct appellant's income from drug sales on the basis of the available evidence. In light of Ulrich's uncontradicted admission that she and appellant had been selling drugs together since late August or early September, we conclude that

appellant was in "business" throughout the seventeen weeks from the beginning of September until the end of December 1972. Relying on the BNE agents' estimate, we also conclude that the trio's sales averaged $3,000 per week during the month of December. Because this estimate was based on at least a full month's observations, furthermore, it is not unreasonable to assume, absent evidence to the contrary, that it reflects the approximate level of sales activity throughout the seventeen week period. (Cf. Hamilton v. United States, 309 F. Supp. 468, 472-473, aff'd, 429 F. 2d 427, cert. denied, 401 U. S. 913 [27 L. Ed. 2d 812].) Finally, the evidence indicates that appellant was the central figure behind the operation, and we therefore assume that he shared at least equally in the sale proceeds, receiving a total of $17,000. Since appellant has made no attempt to prove that he had any allowable deductions or exclusions (compare the Appeal of John and Codelle Perez, supra, with Commissioner v. Sullivan, 356 U. S. 27 (2 L. Ed. 2d 559]), the entire $17, 000 must be treated as taxable income.

While we recognize that this reconstruction is, speculative, it is so only because appellant has failed to present any evidence from which a better computation can be made. Under these circumstances we agree entirely with the following statement of the Tax Court in Shades Ridge Holding Co. , Inc. , supra:

> Admittedly there are gaps in the evidence and our conclusions are at best approximations based on assumptions we have gleaned from the evidence we do have, and unfortunately do not rest entirely on proven facts as we would prefer, but it is our obligation to redetermine the correct amount of tax from what evidence is presented to us, and that we have done. Our only alternatives would be to affirm respondent's determination on the presumption of correctness that attaches thereto, which we do not think would be just [citation], or to make a finding of no deficiency because of lack of sufficient evidence to make an exact determination. To do that would be "tantamount to holding that skillful concealment is an invincible barrier to proof, " [citation] and to reward the person who deliberately refuses to keep records as required by law. [Citations.] (1964 P-H T. C. Memo., at p. 64-1837.)

For the above reasons, we conclude that appellant received a total of $17,000 in unreported taxable income from illegal drug sales during 1972. Respondent's jeopardy assessment shall be modified accordingly.

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 David Leon Rose for reassessment of a jeopardy assessment of personal income tax in the amount of $4,455 for the year 1972, be and the same is hereby modified in accordance with this opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 8th day of March, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Executive Secretary