

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
burr McFarland lyons)

For Appellant: Patrick J. Briggs
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

David M. Hinman
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 Burr McFarland Lyons for reassessment of a jeopardy assessment of personal income tax in the amount of \$5,870.00 for the period beginning January 1, 1972, and ending December 3, 1972.

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On December 1, 1972, undercover police officers from the ElCajon Police Department attempted to purchase 30 kilos of marijuana from one John Doe.— John agreed to the sale and went to obtain the marijuana from his contact. About 45 minutes later, however, he telephoned the officers and told them that "the man with the kilos" had refused to go through with the sale.

Two days later, on December 3, the undercover officers received a telephone call from John Doe and an individual referred to as "the man that had the kilos." This second individual, later identified as appellant, arranged to meet the officers in a nearby parking lot and sell them 30 kilos of marijuana for \$135 per kilo. That evening the officers met appellant and John Doe at the parking lot, and, after observing 30 kilos of marijuana in John's vehicle, arrested both suspects. The officers then went to appellant's home, where they discovered and seized an additional 70 kilos of marijuana.

At the time of his arrest appellant was carrying a revolver concealed under his clothing. Subsequent investigation revealed that he had applied for a concealed weapon permit on October 21, 1971, and that the permit had been issued the following month.

Respondent issued the jeopardy assessment in question on December 6, 1972. The amount of tax assessed therein was based on estimated taxable income from narcotic sales of \$66,150.00. This figure was computed by assuming that appellant had sold an average of 10 kilos of marijuana each week during the 49 weeks of the assessment period for an average selling price of \$135 per kilo. No deductions or exclusions were allowed from gross receipts in computing taxable income. Appellant petitioned for a redetermination of the assessment, but the petition was denied and this appeal followed.

1/Respondent has requested that, in cases involving alleged narcotic sales, the identities of persons not party to the appeal be kept confidential.

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Both the federal and state income tax regulations require each taxpayer to maintain such accounting records as will enable him to file a correct return. (Treas. Reg. §1.446-1(a)(4); Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4).) If the taxpayer does not maintain such records, the taxing agency is authorized to compute his income by whatever method will, in its opinion, clearly reflect income. (Int. Rev. Code of 1954, § 446(b); Rev. & Tax. Code, § 17561, subd. (b).) Mathematical exactness is not required. (Harold E. Harbin, 40 T.C. 373, 377.) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of disproving 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 are not supported by the evidence. (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. (Shades Ridge Holding Co., Inc., supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

The instant appeal is similar to a number of cases which have recently come before this board. In these cases the taxpayer has typically been arrested under circumstances which indicate that he was engaged in the narcotics traffic. The local police notify respondent of the arrest, and respondent then attempts to reconstruct any income which the taxpayer may have derived from sales of narcotics. For some reason which is not readily apparent, in these cases respondent does not usually use any of the more traditional methods of reconstructing income, such as the networth method, the bank deposit method, or the cash expenditures method. Rather, respondent has adopted a system which may be termed the "projection method": Respondent first determines the taxpayer's income for a base period, usually one week, then projects this figure over the entire period of sales activity to yield the taxpayer's total income.

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Like any method of reconstructing income, the projection method is somewhat speculative. For example, it rests on a hypothesis that the amount of sales during the base period is representative of the level of sales activity throughout the entire projection period, a hypothesis which may or may not be true. (Compare Pizzarello v. United States, 408 F.2d 579, cert. denied, 396 U.S. 986 [24 L. Ed. 2d 450] with Hamilton v. United States, 309 F. Supp. 468, aff'd, 429 F.2d 427, cert. denied, 401 U.S. 913 [27 L. Ed. 2d 812].) The speculation is compounded, furthermore, when the projection method is applied to reconstruct income from suspected illegal activities. Since illegal activities are generally carried out covertly, there is seldom any hard evidence on which to base the reconstruction. In the narcotics cases which have been brought to our attention, assumptions and estimates rather than facts have therefore often been used to fill in critical elements of the formula, including the average selling price of the drugs, the number of sales during the base period, and the length of time during which the taxpayer has been involved in the narcotics traffic.

Because of the difficulty inherent in obtaining evidence in cases involving illegal activities, the courts have generally recognized that the use of some assumptions must be allowed in cases of this sort. To hold otherwise, as one court has pointed out, would be "tantamount to holding that skillful concealment is an invincible barrier to proof'...." (Shades Ridge Holding-Co., Inc., supra.) However, the courts also recognize the dilemma facing a taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), he is put in the position of having to prove a negative -- that he did not receive the income attributed to him. This is at best a difficult task, and in practice it may often turn out to be nearly impossible. Therefore, 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 require, that each assumption involved in the reconstruction be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565; Willits v. Richardson, 497 F.2d 240; Shapiro v.

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Secretary of State, 499 F.2d 527, aff'd sub nom. Commissioner v. Shapiro, _____ U.S. ____ [47 L. Ed. 2d 278]; Aguilar v. United States, 501 F.2d 127; Rinieri v. Scanlon, 254 F. Supp. 469; see also Appeal of David Leon' Rose, supra; Appeal of Nicholas H. Obritsch, Cal. St. Bd. of Equal., Feb. 17, 1959.) 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, aff'd sub nom. United States v. Dono, 428 F.2d 204.) If such evidence is not forthcoming, the assessment is arbitrary and must therefore be reversed or modified. (Appeal of David Leon Rose, supra.)

In the instant case, respondent was informed by the El Cajon Police Department that appellant was dealing in marijuana, and it therefore attempted to reconstruct his income from narcotics sales. Respondent apparently made little or no independent investigation of the case, but rather relied almost exclusively on the reports of the arresting officers. Because of the lack of evidence, furthermore, respondent found it necessary to resort to several assumptions in making the reconstruction. First, since appellant was in possession of a total of 100 kilos of marijuana on the day he was arrested, the arresting officers and respondent assumed that his turnover was approximately 10 kilos per week. Secondly, since appellant had charged the officers \$135 per kilo, respondent inferred that that was the average selling price for each alleged sale. Finally, respondent presumed that appellant had been selling narcotics for at least 49 weeks prior to his arrest, that is, since January 1, 1972.

We express no opinion concerning the reasonableness of the first two assumptions. The third assumption, however, concerning the duration of the projection period, is crucial to the resolution of this appeal. Respondent offers only one argument to justify this assumption. Since appellant was armed with a concealed revolver when he attempted to sell marijuana to the undercover officers, respondent argues, he must have carried the weapon to protect himself while selling narcotics. And since appellant had applied for a concealed weapon permit on October 21, 1971, respondent believes it is reasonable to assume that he was

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engaged in the narcotics traffic at that time. Needless to say, we find this argument less than persuasive. The fact that appellant had a permit to carry a concealed weapon throughout the year does not indicate that he was selling marijuana throughout the year.

The evidence in this case certainly establishes that appellant was engaged in the narcotics traffic on December 3, 1972. On that day he was arrested while attempting to sell 30 kilos of marijuana to undercover police officers. The arresting officers also discovered an additional 70 kilos of marijuana at appellant's home, a quantity large enough to create an inference that he possessed the marijuana for sale. These circumstances, however, fall far short of the evidence which has been present in previous cases where we have sustained or partially sustained reconstructions of income from narcotics sales.

For example, in the Appeal of Walter L. Johnson, decided September 17, 1973, and the Appeal of David Leon Rose, supra, the taxpayer or an accomplice had admitted selling drugs for a number of months. Similarly, in the Appeal of Clarence P. Gonder, decided May 15, 1974, information in the police investigation reports and the taxpayer's probation report indicated that the taxpayer had been selling drugs for at least six months. And in the Appeal of John and Cqdelle Perez, decided February 16, 1971, police officers had observed the taxpayer complete a number of narcotics sales over a 49 day period. In the instant case, however, there is no evidence of any completed sales of marijuana, let alone evidence to indicate that appellant had been selling drugs for 49 weeks prior to his arrest.

The situation presented by this appeal is similar to Pizzarello v. United States, supra. In that case there was evidence in the record to indicate that the taxpayer had been engaged in gambling activity for at least two weeks. The Internal Revenue Service issued a jeopardy assessment against him on the assumption that he had received unreported income from gambling over a five year

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period. The taxpayer sought to enjoin levy of the assessment, and the issue before the Court of Appeals was "whether the Government has a chance of prevailing... 'under the most liberal view of the law and the facts.' [Citation.]"

(408 F.2dat 583.) Despite the evidence of some gambling activity, the court held that the government could not possibly prevail, observing that "there is no proof in the record before us that Pizzarello operated as a gambler for five years... .No court could properly make such inferences without some foundation of fact." (408 F.2dat 583.)

Similarly, in this case, there is evidence in the record to indicate that appellant was dealing in marijuana on the day he was arrested. There is no evidence at all, however, to induce a reasonable belief that appellant was connected with any selling activity prior to that date. Absent such evidence, we must conclude that the assessment was arbitrary and without foundation in fact. (Pizzarello v. United States, supra; Appeal of Nicholas H. Obritsch, supra; Appeal of David Leon Rose, supra.)

Horack v. Franchise Tax Board, 18 Cal. App. 3d 363 [95 Cal. Rptr. 7171, is not to the contrary. The issue in that case was whether respondent's seizure of certain funds pursuant to a jeopardy assessment was proper. The court held only that the facts of that case justified such a jeopardy seizure prior to an administrative review of the correctness of the assessment, and did not consider the question of whether the facts supported respondent's reconstruction of the taxpayer's income. (See also Dupuy v. Superior Court, 15 Cal. 3d 410 [124 Cal. Rptr. 900; 541 P.2d 540].)

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

