BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PETER 0. AND SHARON J. STOHRER)

Appearances:

For Appellants: David L. Wasserman
Attorney at Law

For Respondent: Brian W. Toman
Counsel

O P I N I O N

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 Peter 0. and Sharon J. Stohrer for reassessment of jeopardy assessments in the amounts of $8,459.60 for the year 1973 and $1,335.00 for the period beginning January 1, 1974, and ending March 22, 1974.

Two issues are presented: First, whether there is evidence in the record to support respondent's reconstruction of income allegedly earned from illegal drug

sales; and second, if there is, whether appellants have' met their burden of proving 'that the reconstruction is erroneous.

On March 22, 1974, appellant Peter Stohrer was arrested while attempting to sell five pounds of marijuana to a police informant for $600. Shortly thereafter his wife Sharon was arrested at the couple's home, where police officers discovered and seized another 10 kilos (approximately 22 pounds) of marijuana. Subsequently appellants were both charged with various drug-related offenses. Peter ultimately pled guilty to one count of transportation of marijuana'in violation of Health and Safety Code section 11360, but the charges against Sharon were dismissed.

At the time of his arrest, according to a "crime report" prepared by the arresting officers, Peter admitted that he had transported 100 kilos of marijuana from Chula Vista to Sacramento every week or two. In addition, according to letters written to respondent by three of the arresting officers, at the time of his arrest Peter also said that he had been transporting marijuana to Sacramento "for the last couple of years." These letters are dated January 31, 1975, more than ten months after Peter's arrest, and the language of all three letters is substantially identical.

In'a presentence interview with a probation officer after Peter's guilty plea, Peter claimed that he had first decided to sell marijuana on March 20, 1974, two days prior to his arrest. 'He stated that he had purchased 20 pounds of the drug on that day for $1,800, paying $1,000 down and agreeing to pay the remaining $800 later. He said he was in the process of selling this 20 pounds when 'he was arrested.

On March 25, 1974, respondent issued jeopardy assessments against appellants in' the amounts of $6,250. for the year 1973 and $7'55 for the period January 1, 1974, to March 22, 1974. The record does not reveal how these figures were computed. After two hearings with appellants or their representative., respondent increased the assessments to the amounts now at issue. These amounts are based

on estimated gross receipts from marijuana sales of $130,000 for 1973 and $30,000 for the first 12 weeks of 1974, computed by assuming that Peter had sold an average of 25 pounds of marijuana each week for $100 per pound. No deductions or exclusions were allowed from gross receipts in computing taxable income.

Appellants did not report any income from narcotic sales on their joint 1973 personal income tax return. On their joint 1974 return, however, they reported $175 as "miscellaneous income." Appellants concede that $150 of this amount represents income from the sale of marijuana. On this appeal, appellants' principal contention is that their returns for 1973 and 1974 were correct as filed, and that respondent's jeopardy assessments are arbitrary, capricious, and without foundation in fact.

In the Appeal of Burr McFarland Lyons, decided this day, we summarized the law applicable to cases of this sort as follows:

> 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. [Citations.] 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. [Citations.] Mathematical exactness is not required. [Citation.] Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of disproving the computation. [Citation.] 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. [Citation.] 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. [Citations.]

In Lyons, supra, respondent had used the same method to reconstruct the taxpayer's income as it used here. An assumed average weekly income from drug sales

was projected over an estimated period of sales activity. We pointed out that the use of this method involves various assumptions, and that:

> . ..the courts require that each assumption involved in the reconstruction be based on fact rather than on conjecture. (Citations.) 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. (Citation.) If such evidence is not forthcoming, the assessment is arbitrary and must therefore be reversed or modified. (Citation.)

We went on to reverse the assessment in Lyons because there was no evidence in the record to indicate that the taxpayer had in fact been selling drugs throughout the projection period.

The first issue presented in this appeal is whether. there is credible evidence in the record which, if true, would warrant an assumption that Peter was selling marijuana throughout the projection period. Respondent argues that the evidence is sufficient in this regard. It points out, first, that Peter admittedly purchased marijuana from. his contact on credit. Respondent argues that only individuals who had been dealing in marijuana for some time would be worthy of such trust. We are not persuaded, however, that evidence of the credit transaction is sufficient, standing alone, to induce a reasonable belief that Peter had been purchasing marijuana for resale for some 15 months.

Respondent also relies on the letters which it received from the arresting officers. According to these letters, Peter admitted that he had been transporting marijuana "for the last couple of years." We do not find these letters to be credible evidence. If Peter had in fact made this statement, which he adamantly denied at the hearing on this appeal, the arresting officers would presumably have recorded it in the "crime report" prepared shortly after his arrest. 'The statement is not mentioned

in the "crime report," however, but instead appears for the first time in the letters written to respondent. The language in each of these letters is practically identical, indicating that the officers collaborated in writing them. Moreover, the letters were not written until more than ten months after Peter's arrest, and no explanation has been offered as to why the arresting officers waited so long before telling anyone of this alleged admission. Under these circumstances, the chances for errors in memory are so great that we cannot accept these letters as accurate statements of what was said at the time of Peter's arrest.

Since there is no credible evidence in the record to indicate that Peter was selling marijuana throughout the projection period, the assessment for 1973 is arbitrary and must be reversed. (Appeal of Burr McFarland Lyons, supra.) As explained below, however, there is evidence in the record which, if true, would justify an assumption that Peter did sell some marijuana during 1974, although not in the amounts claimed by respondent.

At the time he was arrested, according to the "crime report," Peter admitted having transported 100 kilos of marijuana to Sacramento every week or two. On its face, this evidence indicates that Peter transported at least 100 kilos of the drug (about 220 pounds). And unlike the letters which the arresting officers sent to respondent, the "crime report" was apparently prepared shortly after Peter's arrest, and therefore is not inherently untrustworthy. Furthermore, Peter and his wife only had about 27 pounds of marijuana in their possession when they were arrested, and this leaves 193 pounds unaccounted for. Since Peter was attempting to sell marijuana when he was arrested, it is reasonable to assume that he transported the marijuana for sale and actually sold the missing 193 pounds. Finally, since Peter attempted to sell five pounds for $600, respondent's assumption that he sold the marijuana for an average sales price of $100 per pound is not unreasonable. On the basis of this evidence, we modify the assessment for 1974 to reflect gross receipts from marijuana sales of $19,300 (193 pounds of marijuana sold at $100 per pound). [Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.) Thus modified, the assessment for 1974 has a foundation in fact and is not arbitrary or unreasonable.

The second issue in this appeal is whether appellants have met their burden of proving that the assessment for 1974, as modified above, is erroneous. The parties agree that, in order to meet this burden, appellants must persuade us that the assessment is erroneous by a preponderance of the evidence. (See Estate of Willie James Gary, T.C. Memo., June 14, 1976.) "Preponderance of the evidence" means "such evidence as, when weighed with that opposed to it, has more convincing force, and from which it results that the greater probability of truth lies therein." (In re Corey, 230 Cal. App. 2d 813, 823 [41 Cal. Rptr. 379].)

Appellants attempt to meet their burden with a two pronged attack. First, they offer a financial statement summarizing their earnings for the period January 1, 1972, through March 22, 1974. The statement indicates that they did not receive more than $150 income from marijuana sales during the first part of 1974. As respondent points out, however, it is not difficult to conceal income from illegal transactions. A financial statement which does not mention such income amounts to no more than a bare allegation that the income was not received. When weighed against the evidence that Peter transported substantial amounts of marijuana to Sacramento for sale, therefore, appellants' financial statement, standing alone, is not sufficient to persuade us that their earnings from such sales were limited to $150. (See Appeal of David Leon Rose, supra.)

Secondly, appellants rely on Peter's testimony at the oral hearing in this matter. This testimony was substantially similar to the story he told at his presentence interview. He claimed that he had made only one sale of marijuana before this arrest, and that he had earned only $150 from that sale. Peter also testified that he had not made the admission attributed to him in the "crime report" that he had transported 100 kilos of marijuana to Sacramento.

Peter's story is unconvincing. In his presentence interview Peter claimed to have purchased only 20 pounds of marijuana for resale; but he and his wife had 27 pounds of the drug in their possession when they were arrested. Moreover, Peter's testimony was vague and inconclusive concerning the amount of marijuana which he purchased for resale and the amount which he actually sold. Under these circumstances, we find that the "crime report" is more likely to be true than Peter's testimony..

For the above reasons, we conclude that appellants have failed to meet their burden of proof, and we therefore sustain the modified assessment for 1974. However, there is one additional issue in this case which, although not raised by the parties, deserves to be mentioned. In making the assessments in question, respondent treated all of appellants' alleged gross receipts from marijuana sales as taxable income, without any allowance for the cost of the marijuana to appellants. Respondent took this action in reliance on dicta appearing in the Appeal of John and Codelle Perez, decided by this board on February 16, 1971. In Perez we noted that federal case law permits the disallowance of business expense deductions for expenditures which are against public policy (see, e.g., Finley v. Commissioner, 255 F.2d 128), and suggested that the federal authorities would probably extend this rule, in an appropriate case, to disallow a cost of goods sold exclusion for illegal narcotics.

It has recently come to our attention, however, that the federal rule has not been so extended. The Internal Revenue Service permits taxpayers engaged in the narcotics traffic to exclude the cost of the drugs from gross receipts in computing taxable income, and in fact, in cases where the Service estimates the taxpayer's income from drug sales, it also estimates the allowable cost of goods sold. (See, e.g., Commissioner v. Shapiro, ___ U.S. ___ [47 L. Ed. 2d 278, footnotes 4 and 9]; Estate of Willie James Gary, supra; Alice R. Avery, T.C. Memo., April 22, 1976.) In view of this federal practice, respondent's failure to allow any cost of goods sold exclusion in narcotics cases is questionable, despite the above mentioned dicta from Perez. As far as this case is concerned, if either party wishes to pursue this matter, they may do so by filing a timely petition for rehearing.

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,

Appeal of Peter 0. and Sharon J. Stohrer

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 Peter 0. and Sharon J. Stohrer for reassessment of jeopardy assessments in the amounts of $8,459.60 for the year 1973 and $1,335.00 for the period beginning January 1, 1974, and ending March 22, 1974, be and the same is hereby: (1) reversed with respect to the denial of the petition for reassessment of the jeopardy assessment for the year 1973; (2) modified in accordance with the views expressed in the attached Opinion with respect to the jeopardy assessment for the period beginning January 1, 1974, and ending March 22, 1974. In all other respects the action of the Franchise Tax Board is sustained.-

Done at Sacramento, California, this 15th day of December, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____ Secretary