77-SBE-028

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FELIX L. ROCHA)

For Appellant: Roger D. Randall
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Kendall Kinyon
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 Felix L. Rocha for reassessment of jeopardy assessments of personal income tax in the amounts of $4,204.20 for the year 1972, and $11,327.26 for the period January 1 through June 4, 1973.

Appeal of Felix L. Rocha

The principal issue is whether respondent's reconstruction of appellant's income from narcotics sales is reasonable.

During April 1973, the Bureau of Narcotic Enforcement (BNE) and the Kern County Sheriff's Office received information from an informant that Samuel Gonzales was selling heroin in ounce quantities in the Bakersfield area. Further information indicated that appellant, a nonaddict, was Gonzales' supplier. On April 27, 1973, Velasquez, a BNE undercover agent, purchased one ounce of heroin from Gonzales. On May 4, Velasquez purchased an 'additional two ounces of heroin from Gonzales with $1,400 in prerecorded state funds. Again, on June 4, 1973, Velasquez was able to set up another purchase of two ounces of heroin from Gonzales. The nature of this transactionwas similar to the prior purchases. Velasquez gave Gonzales $1,400 in prerecorded funds and they agreed to meet at a later time for the transfer. Thereafter, surveillance.teams observed Gonzales contact appellant and then drive to the prearranged meeting place. At the meeting place, Gonzales met Velasquez and gave him the two ounces of heroin. At that time Gonzales was arrested and found to be in possession of $100 of the $1,405 in prerecorded funds.

After the arrest of Gonzales, agents proceeded to appellant's residence and arrested him for the sale of heroin. A search of the residence was conducted pursuant to a search warrant which revealed: $1,300 in prerecorded buy money, a glass jar containing $14,000; $140 in appellant's wallet: and four and one-half ounces of heroin.

After his arrest, appellant agreed to assist BNE agents in apprehending other narcotics dealers in exchange for favorable treatment on the charges pending against him. Pursuant to this agreement, appellant, in conjunction with BNE agents, set up a 40 to 50 ounce buy of heroin from his supplier Rafael Bobadilla. On September 13, 1973, appellant and BNE agents met with Bobadilla and purchased 44 and one-half ounces 'of heroin at $450 an ounce. Bobadilla was arrested for selling heroin and brought to trial in December 1973, where appellant was a prosecution witness. The original charges against appellant were dismissed.

Appeal of Felix L. Rocha

After becoming aware of appellant's narcotics activities, respondent determined appellant's *income* for the period January 1, 1973 through June 4, 1973, to be $151,200, and issued a jeopardy assessment in the amount of $15,732. On the same day respondent issued an order to withhold personal income taxes to the BNE and obtained $14,140 ($15,440 seized less $1,300 in state marked money).

Appellant petitioned for reassessment. In conjunction with the petition appellant filed a 1973 return and an amended return for 1972. The 1972 amended return reported gross sales of narcotics in the amount of $41,400 with a $31,050 reduction for cost of goods sold, leaving a net profit of $10,350. The 1973 return reported gross narcotics sales of $27,600 with a reduction of $20,700 for cost of goods sold, leaving a net profit of $6,900.

After reviewing the returns, respondent issued a jeopardy assessment for 1972 increasing income from narcotics sales by $48,150. At the same time, respondent issued its notice of action for 1973 increasing income from narcotics sales by $129,600. Respondent's determinations were based on sales of 300 ounces (15 transactions at 20 ounces each) of heroin at $650 per ounce for the 74 week period January 1, 1972 through June 4, 1973. No deductions or exclusions were allowed from gross receipts in computing taxable income. Since appellant stated that he kept no records of his narcotics business, respondent found it necessary to allocate a portion of the projected income to each of the years in question. This allocation between years was made by assuming that appellant initially started out selling lesser amounts and progressively worked his way to the level of a volume wholesale distributor.

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 fails to 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, S.17561, subd. (b).) 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 disproving the computation. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963).) 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 (5th Cir. 1966).) In such a case, the reviewing authority may revise the computation on the basis of all the available evidence without regard to the presumptionof correctness. (Shades Ridge Holding Co., Inc., supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

While appellant does not dispute the principles announced above, he does contend that respondent failed to properly and reasonably compute his income for the period in question.

Respondent's ultimate determination of the amount of appellant's income from the sale of heroin was derived from appellant's own testimony at the trial of Rafael Bobadilla (People v. Bobadilla, Kern County Superior Court Case No. 16309, Dec. 1973.) where he was a witness for the prosecution. At that proceeding appellant testified under oath and without contradiction that he had been dealing in heroin for "a couple of years." Respondent's jeopardy assessments covered the 74 week period January 1, 1972 through June 4, 1973. Appellant does not seriously contend that respondent's determination of a 74 week period was either improper or unreasonable. Accordingly, we conclude that appellant was in fact dealing in heroin from January 1, 1972 until June 4, 1973.

At the same proceeding appellant testified that he purchased heroin in 20 ounce quantities from a man named Chico three or four times. Appellant also testified that he bought 20 ounce quantities from Bobadilla about three or

four times. However, on re-cross examination appellant admitted that he could have purchased heroin from Bobadilla as many as 12 times in the last year although he continued to maintain that he had received heroin only three times from Chico. Based on appellant's testimony respondent determined that he purchased and sold 300 ounces of heroin (15 purchases at 20 ounces) during the period in issue.

Appellant contends that he purchased no more than 120 ounces of heroin during the 72 week period in question. Appellant argues that he testified he made three or four 20 ounce purchases from Chico and three or four 20 ounce purchases from Bobadilla. He also points out that he testified he had obtained a total of 120 ounces of heroin from Chico and Bobadilla during the period in question. While there is some testimony in the record which would tend to support appellant's contention, the record also supports respondent's determination that appellant sold 300 ounces of heroin during the period in issue. Bearing in mind that appellant's failure to keep or produce any records of his illegal transactions must be weighed against him[1/] (see Halle v. Commissioner, 175 F.2d 500, 503 (2d Cir. 1949), we cannot conclude that respondent's determination of the quantity of heroin sold was improper or unreasonable.

Similarly, we conclude that respondent's determination of $650 per ounce as the gross selling price for the 300 ounces of heroin sold is supported by the evidence and is not unreasonable. This determination is supported

1/ Appellant relies on the case of Marchetti v. United States, 390 U.S. 39 [19 L. Ed. 2d 889] (1968) for the proposition that the taxing agency cannot require a person engaged in illegal activities to maintain elaborate records and then penalize them for not keeping those records. We believe appellant has overextended Marchetti which held that since the federal occupational-and excise tax on gambling required disclosure only of gamblers, the law violated the gamblers Fifth Amendment privilege against self incrimination. (See United States v. Sullivan, 274 U.S. 259 [71 L. Ed. 10371 (1927); see also Justice Brennan's concurring opinion in Marchetti reported at 390 U.S. 72.) Since personal income tax returns are neutral on their face, the taxpayer may not refuse to keep records or file returns. (United States v. Sullivan, supra.)

by the fact that at the time of his arrest, Samuel Gonzales told.BNE agents that he was paying appellant $650 an ounce for heroin. Furthermore, after the June transaction when agents purchased two ounces of heroin from Gonzales for $700 per ounce, Gonzales was found with $100 in marked money while the remaining $1300 was found in appellant's possession. This indicates that appellant was selling heroin for $650 per ounce.

In assigning the 300 ounces of heroin sold by appellant over the 74 week period in issue, respondent allocated the sales to reflect a progressive.buildup in the volume of appellant's sales. -This resulted in sales of 90 ounces being assigned to the entire year 1972, while sales amounting to 210 ounces were assigned to the 22 week period January 1 through June 4, 1973. There is some evidence in the record to indicate that appellant purchased the 240 ounces of -heroin from Bobadilla during the twelve months immediately prior 'to his arrest and that he purchased the 60 ounces of heroin from Chico prior to that time. However, there is no evidence which would support respondent's specific allocation of the sales. Accordingly, since this aspect of respondent's determination is not supported by the evidence it cannot stand. (Shades Ridge Holding Co.,' Inc., supra.) However, the evidence is sufficient to support a determination that appellant sold 240 ounces of heroin during the last 12 months in issue while the remaining 60'ounces were sold during the period January 1, 1972 to June 4, 1972. Therefore. respondent's determination must be revised in this respect. (See Shades Ridge Holding Co., Inc., supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

Next, appellant argues that he must be allowed a deduction or exclusion for cost of goods sold. Respondent's denial of an exclusion for cost of heroin sold was based upon dicta appearing in the Appeal of John and Codelle Perez, decided by this board on February 16, 1971. (See also Appeal of Clarence P. Gonder, Cal. St. Bd. of Equal., May 15, 19'74.) In Perez we noted that federal case law permits the disallowance of certain business expense deductions for expenditures which are against public policy. (See, e.g., Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 [2 L. Ed. 2d 562] (1958); Finley v. Commissioner, 255 F.2d 128 (10th Cir. 1958); but see Commissioner v. Sullivan, 356 U.S. 27 [2 L. Ed. 2d 5591 (1958).) We also suuaested that in an appropriate case, the federal authorities would

probably extend this rule to disallow a cost of goods sold exclusion for illegal narcotics. However, the federal rule has not been so extended. The Internal Revenue Service permits taxpayers engaged in the narcotics traffic to exclude the cost of drugs sold from gross receipts in computing taxable income. Additionally, in cases where the Service estimates a taxpayer's income from drug sales, it also estimates the allowable cost of goods sold. -(See, e.g., Commissioner v. Shapiro, S . [47 L. Ed. 2d 278, footnotes 4 and 9] (1976); Estate of Willie James Gary, T.C. Memo., June 14, 1976: Alice R. Avery, T.C. Memo., April 22, 1976.)

In support of their respective positions the parties rely on two cases decided by the United States Supreme Court on the same day. Respondent maintains that Tank Truck Rentals, Inc. v. Commissioner, supra, is controlling, while appellant asserts that Commissioner v. Sullivan, supra, is determinative.

In Tank Truck the Court upheld the disallowance of overweight fines paid by a trucking firm to state and local governments. The thrust of Tank Truck is that an otherwise deductible expense may be denied if allowance would severly frustrate federal or state policy proscribing particular types of conduct where the policies are evidenced by some governmental declaration. In Sullivan the taxpayer ran illegal bookmaking operations and claimed deductions for the amounts expended to lease premises and hire employees for the conduct of the illegal gambling operation. Although recognizing the distinction drawn by Tank Truck, the Court, nevertheless, allowed the claimed rent and wage deductions on the basis that the expenditures were only remotely related to the illegal act of gambling.

Respondent recognizes the distinction between Tank Truck and Sullivan. However, respondent points out that, in view of the various provisions of the Health- and Safety Code, there is a sharply defined state policy against the purchase, possession, or sale of heroin without a valid written prescription. Therefore, respondent concludes that the very expenditure for which appellant seeks a deduction is prohibited by statute.,

We do not believe that either Tank Truck or Sullivan controls the present inquiry. It is important to note that both cases dealt with expenses claimed as a deduction from gross income in deriving adjusted gross income or taxable income. Neither case dealt with the exclusion of a return of capital such as cost of goods sold from gross receipts in determining gross income. The California personal income tax is a tax on net income, not a tax on gross receipts or a tax on capital. Gross receipts include receipts which may constitute a return of capital as well as income. Since a net income tax properly may not tax the return of capital it is essential that cost of goods sold, which constitutes a return of capital, be allowed as an exclusion from gross receipts in arriving at the income which is subject to tax under the revenue laws. (Doyle v. Mitchell Brothers Co., 247 U.S. 179 [62 L. Ed. 1054] (1918).)

We are aware of no case where a court upheld a disallowance of the entire amount claimed as cost of goods sold, even in the context of an illegal enterprise.[2/] In fact, as noted above, even the Internal Revenue Service permits taxpayers engaged in narcotics traffic to exclude their cost of goods sold from gross receipts in computing taxable income. If we adopted respondent's position we

2/ Some cases have held that certain expenditures incurred in excess of statutory wage or price ceilings and, thus, in violation of public policy, are not deductible even though the expenditures may constitute part of cost of goods sold. (See, e.g., Pedone v. United States, 151 F. Supp. 288 (Ct. Cl.) cert. denied 355 U.S. 829 [2 L. Ed. 2d 421 (1957); Sidney Zehman, 27 T.C. 876 (1957), aff'd per curiam sub nom. Solon Decorating Co. v. Commissioner, 253 F.2d 424 (6th Cir. 1958); Weather-Seal Manufacturing Co., 16 T.C. 1312 (1951), aff'd per curiam 199 F.2d 376 (6th Cir. 1952); but see Lela Sullinger, 11 T.C. 1076 (1948).) However, these cases may be distinguished by the fact that only the excess expenditure was disallowed. In effect, the expenditure claimed as a deduction was merely questioned and properly redetermined as to amount for tax purposes. (See Weather-Seal Manufacturing Co., supra.)

would, in effect, tax appellant upon his gross receipts while all other enterprises would be taxable on the basis of their net income. If that choice is to be made, we believe the Legislature should make it. In this respect, we note that respondent is charged with the responsibility for collecting revenues not punishing criminals. Accordingly, we conclude that, upon a proper showing, a taxpayer, even though engaged in illegal narcotics traffic, is entitled to a reduction in gross receipts by the amount of his cost of goods sold in computing gross income.

Next, we turn to the question whether appellant has established the amount of cost of goods sold to which he is entitled. The record indicates that appellant testified at the Bobadilla trial that he always paid $450 per ounce for the heroin he purchased. The price of $450 per ounce is corroborated by the fact that BNE agent Velasquez also paid $450 per ounce when he made the September purchase from Bobadilla, appellant's supplier. Based on this evidence, we can conclude that appellant should be allowed an exclusion for cost of goods sold in the amount of $450 per ounce for the 300 ounces of heroin.

Finally, appellant contends that the jeopardy assessment prodedures established by sections 18642 and 18643 of the Revenue and Taxation Code are unconstitutional.

It is a well established policy of this board to refrain from ruling on a constitutional question in an appeal involving an assessment. This policy is based upon the absence of any specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of an unfavorable decision, and we believe that such review should be available for questions of constitutional importance. (Appeal of Harlan R. and Esther D. Kessel, Cal. St. Bd. of Equal., March 27, 1973; Appeal of C. Pardee Erdman, Cal. St. Bd. of Equal., Feb. 18, 1970.) However, in this regard, we should note that the recent California Supreme Court case of Dupuy v. Superior Court, 15 Cal. 3d 410 [124 Cal. Rptr. 900; 541 P.2d 5401 (1975), upheld the constitutionality of procedures such as those applied in this matter.

Appeal of Felix L. Rocha

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,

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 Felix L. Rocha for reassessment of jeopardy assessments of personal income tax in the amounts of $4,204.20 for the year 1972, and $11,327.26 for the period January 1 through June 4, 19.73, 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 3rd day of February, 1977, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____ Executive Secretary