BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATF OF CALIFORNIA

In the Matter of the Appeal of)
)
FRANK WILLIAM WHITNEY)

For Appellant: David Lafaille
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Jeffrey M. Vesely
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Frank William Whitney for redetermination of a jeopardy assessment of personal income tax in the amount of $34,300.00 for the period January 1, 1975, through August 22, 1975.

On August 22, 1975 appellant was arrested by federal officers, following his indictment by a federal grand jury on various drug charges, including possession and distribution of heroin on November 12, 1974, and January 23, 1975. The indictment followed a year of investigation which was prompted by information supplied by confidential informants who had purchased drugs from appellant between October 1973 and January 1974. The investigation began in August 1974, and it included "controlled purchases" of heroin from appellant and others to whom he allegedly supplied narcotics. Two of these purchases, at $1,200 and $1,400 an ounce, took place during the appeal period.

At the time of the arrest, appellant's home was searched and various items were seized, including guns, narcotics, drug paraphernalia and $22,960.00 in cash. After learning of the arrest, respondent determined that appellant had received taxable income from drug sales during the period January 1, 1975, through August 22, 1975. Respondent estimated this income to be $320,000.00 and issued the jeopardy assessment in question on August 22. Pursuant to Revenue and Taxation Code section 18817, respondent obtained the $22,960.00 which federal agents had seized at th-e time of appellant's arrest. Appellant petitioned for reassessment on August 28, 1975.

On January 16, 1976, appellant was convicted on all counts of the indictment, was fined $5,000 and sentenced to ten years' imprisonment. The jeopardy assessment was affirmed on May 11, 1976, and this appeal followed. The issue presented is whether respondent's reconstruction of appellant's income was reasonable.

California income tax regulations require each taxpayer to maintain sudh accounting records as will enable him to file a correct return. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4).) In the absence of such records, respondent is authorized to compute the taxpayer's income by whatever method will, in its opinion, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b).) A reasonable reconstruction is presumed correct, but the presumption is rebutted if 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., 1164,275 P-H Memo. T.C. (1964), affd. sub nom. Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976) In other words, 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. (Appeal of James Godfrey Gallardo, Cal. St. Bd. of Equal., Sept. 28, 1977; App of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.)

This board has decided a number of appeals in which the evidence indicated that the taxpayer was involved in narcotics traffic. In those cases, respondent adopted a method of reconstructing income termed the "projection method," in which respondent first determines the taxpayer's income for a base period, then projects this figure over the entire period of sales activity to yield the taxpayer's total income.

Here, respondent has relied on various sources of evidence as the basis for its reconstruction, including investigation and arrest reports, transcripts of appellant's trial and informants' statements. Appellant contends that the evidence is hearsay and therefore inadmissible, that the evidence is inadequate to support the reconstruction, and further, that respondent must at least allow appellant an exclusion for the cost to him of heroin sold.

Our first observation is that clearly there is no bar to the admission of the evidence herein. The regulations which govern appeals to this board permit the consideration of hearsay evidence, provided it is relevant and "is the sort of evidence on which responsible persons are accustomed to rely in the conduct of serious affairs." (Cal. Admin. Code, tit. 18, § 5035, subd. (c).) Certainly, a history of appellant's involvement with the sale of narcotics is relevant, and appellant's objections have been considered by us in assigning weight to the evidence. Accordingly, for the reasons expressed below, we conclude that respondent's estimates of the duration and amount of drug sales is reasonable, but the reconstruction must be modified to reflect appellant's costs.

We do not question respondent's assumption that appellant sold narcotics continuously from November 1973, until his arrest and we believe appellant has misplaced his reliance on the Appeal of Robin L. Prewitt, decided by this board on December 15, 1976. In the Prewitt appeal, we modified the proposed assessment because certain assumptions made by respondent concerning the duration of the drug sales and the average quantity of drugs sold daily were totally unsupported by the evidence. Such is simply not the case in the instant appeal, where the investigation conducted by federal agents produced an extensive

record of incriminating evidence, too lengthy to reproduce here, which provides a clear factual basis for the proposed assessment. In addition, respondent has considered only heroin sales in its reconstruction, even though there is evidence of other.drug traffic. Thus, appellant's average daily income as computed is not patently arbitrary or unreasonable, particularly in light of appellant's known income of only $300 per month in state disability payments. In the absence of contrary evidence, we must sustain respondent's reconstruction of the duration and quantity of drug sales. (Appeal of Walter L. Johnson, Cal. St. Bd. of Equal., Sept. 17, 1973.)

However, we must now consider appellant's contention that respondent must, in its reconstruction, make an allowance for the cost of the heroin to appellant. In the recent Appeal of Peter 0. and Sharon J. Stohrer, decided by this board on December 15, 1976, we noted that the Internal Revenue Service permits such an exclusion and even estimates the allowable cost of goods sold when it reconstructs a taxpayer's income. In a later appeal, that of Felix L. Rocha, decided February 3, 1977, we again considered this issue and concluded 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." Otherwise, the reconstruction is based in part on receipts which cannot be considered taxable income.

We believe that a reconstruction which does not exclude the cost of goods sold is patently arbitrary in the face of cumulative evidence of drug sales activity by the taxpayer, as in the instant case. Respondent, in its brief, relied heavily on evidence of large loans allegedly made by appellant to associates in its determination that appellant was in the "business of selling drugs." Respondent clearly believes that appellant used the profits from sales to acquire more drugs. It cannot then argue, rather inconsistently, that the drugs came into appellant's hands through some other means, such as a gift or by theft, in order to avoid allowing the exclusion of costs.

Our dilemma is that neither party has presented evidence concerning appellant's costs, though we do not doubt that both parties have the ability to reasonably

estimate such figures. 1/ Therefore, we have estimated appellant's costs as best we can under the circumstances, and have determined that those costs are 25 percent of the gross receipts, with the understanding that either party may dispute that amount and file a timely petition for rehearing in order to present concrete contrary evidence.

Accordingly, we conclude that respondent's reconstruction of appellant's income must be modified to reflect an exclusion of 25 percent of the gross receipts as appellant's cost of the heroin sold.

1/ Obviously, appellant knows what his costs were; and in the past, respondent has called upon a drug law enforcement officer, as an expert witness, to establish the price of drugs sold. (See Appeal of Raymond Wesley Rogers, Cal. St. Bd. of Equal., April 6, 1978) It seems reasonable that such an expert could also help establish costs to the seller.

Appeal of Frank William Whitney

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 Frank William Whitney for redetermination of a jeopardy assessment of personal income tax in the amount of $34,300.00 for the period January 1, 1975, through August 22, 1975, be and the same is hereby modified to reflect an exclusion of 25 percent of appellant's gross receipts as appellant's cost of goods sold.

Done at Sacramento, California, this 9th day of January, 1979, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member