BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 80J-700-KS
LARRY R. MAYNARD)

For Appellant: Michael Pancer
Attorney at Law

For Respondent: Jon Jensen
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Larry R. Maynard for reassessment of a jeopardy assessment of personal income tax in the amount of $183,854 for the period January 1, 1979, to October 13, 1979.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the period in issue.

The issue presented by this appeal is whether appellant had unreported income from narcotics trafficking during the period at issue.

On October 12, 1979, a confidential reliable informant (CRI) reported to Los Angeles Police Department Detective Clay Searle that Mark Calicchio had been selling cocaine in the Los Angeles-Orange County area for the prior six months. The CRI also informed Detective Searle that he had recently purchased cocaine from Calicchio. Based upon this and other information supplied by the CRI, Searle obtained a search warrant for Calicchio's residence.

The warrant was executed the next day. Although no persons were found on the premises, quantities of cocaine and drug paraphernalia were found in the house. Later testing of these items revealed that appellant's palm print was on one of the plastic bags containing either cocaine or a cutting agent. In the garage, the police found a Mercedes-Benz automobile which contained appellant's driver's license and other identification in appellant's name. Two briefcases were discovered in the car, one of which contained packages of cocaine and a cutting agent, $74,862 in cash, and undated "pay and owe" sheets which showed records of what were apparently narcotics sales totaling between $4,000,000 and $5,000,000. The other briefcase contained pilot's charts, pilot's logbooks, and a pilot's license in appellant's name. The car was later determined to be registered in appellant's mother's name.

Although his possible involvement in the drug trade was unknown to the police prior to the search of Calicchio's residence, appellant was arrested that day and charged with possession of cocaine, possession of cocaine for sale, and transportation of cocaine. Subsequently, all of the above-described charges filed against appellant were dismissed.

Soon after the raid, respondent was notified of the above discoveries. Respondent proceeded to "reconstruct' appellant's alleged income from cocaine sales. Respondent estimated that appellant had been buying cocaine for $5,000 per kilogram and selling two kilograms of cocaine per week at $75,000 per kilogram for 24 weeks. One-half the net sales proceeds were attributed to Calicchio, resulting in $1,680,000 of taxable income to appellant for the 24-week period that Calicchio was known to have been trafficking in cocaine. Respondent issued a

jeopardy assessment, appellant submitted a petition for reassessment which was subsequently denied, and this appeal followed.

On appeal, appellant contends that respondent has not proven that he was"involved in the trafficking of narcotics or that he received unreported income from the sale of drugs. Accordingly, appellant concludes, respondent's assessment is based on conjecture and is arbitrary.

In general, the existence of unreported income may be demonstrated by any practical method of proof that is available in the circumstances of a particular case. (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of Karen Tomka, Cal. St. Bd. of Equal., May 19, 1981.) In the instant matter, respondent employed the now familiar projection method to reconstruct appellant's income from the alleged sale of cocaine. The projection method based upon statistical analysis and assumptions gleaned from the evidence is an acceptable method of reconstruction. (Mitchell v. Commissioner, 416 F.2d 101 (7th Cir. 1969); Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966): Appeal of David Leon Rose, Cal. St. Bd. of Equal., Mar. 8, 1976.) However, in order to ensure that the use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income that he did not receive, each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Willits v. Richardson, 497 F.2d 240 (5th Cir. 1974); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, ,424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 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. (United States v. Bonaguro, 294 F.Supp. 750 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2nd Cir. 1970); Appeal of Burr McFarland Lyons, supra.) If the reconstruction is found to be based on assumptions lacking corroboration in the record, the assessment is-deemed arbitrary and unreasonable. (Shades Ridge Holding Co., Inc. v. Commissioner, ¶ 64,275 T.C.M. (P-H) (1964), affd. sub nom., Fiorella v. Commissioner, supra.) In such instance, the reviewing authority may redetermine the taxpayer's income on the facts adduced from the record. (Mitchell v. Commissioner, supra; Whitten v. Commissioner, ¶ 80,245 T.C.M. (P-H) (1980); Appeal of David Leon Rose, supra.)

This case presents an unusual factual situation in that the taxpayer is alleged to have received unreported income from the illegal sale of narcotics and yet no actual drug sales by appellant are known to have occurred. Accordingly, we must carefully consider the evidence presented to determine if a connection can be established between appellant, the alleged sale of narcotics, and respondent's determination that appellant received unreported income from those alleged sales. As stated in Llorente v. Commissioner, 649 F.2d 152, 156 (2nd Cir. 1981):

> [T]he evidence of record must at least link the taxpayer with some tax-generating acts, such as the purchase or sale of controlled substances. [Citations.] A mere peripheral contact with illegal conduct is insufficient [to accord a presumption of correctness to the Notice of Deficiency]. ... [The] mere linking of a taxpayer with the drug business will not suffice and ... the presumption will attach only upon a showing that the taxpayer's involvement was sufficient to support an inference that he received or used funds in the course of his engagement in the unlawful activity.

As stated above,' appellant's connection with the drug trade was based upon the assumption that he had been engaged in a drug-selling partnership with Calicchio. This assumption was based upon the discovery of some of appellant's personal effects on Calicchio's property during the police raid. There is, however, no evidence to support this alleged partnership. The information provided by the CRI to Detective Searle incriminated only Calicchio. The affidavit signed by Detective Searle never mentioned the existence of a partnership between appellant and Calicchio. At appellant's preliminary hearing, the detective testified that he did not know of appellant's alleged involvement in the drug trade until the discovery of the car in Calicchio's garage'. Accordingly, the police records do not support respondent's position that appellant and Calicchio were "partners." This conclusion is underscored by the fact that all of the criminal charges pending against appellant were dismissed, even those involving the mere possession of cocaine.

Furthermore, no known sale of narcotics can be traced to appellant at any time, let alone during the period in question. The "pay-owe" sheets found in the

car which allegedly recorded drug sales were undated. Without any way of attributing those alleged sales to the period in question, the sheets are meaningless for the purposes of this appeal. It is equally unrevealing that separate drug supplies were found in the car and in the house. This fact would support a conclusion that the two were independent drug dealers as well as it would support the assumption that the men were partners. The discovery of appellant's palm print on an easily transportable bag of cocaine, or a cutting agent, is also an ambivalent finding supporting appellant's independence as easily as it would support the speculation that he was a drug seller superior, equal, or inferior to Calicchio in some drug organization. Even if we assume that he was part of Calicchio's operation, there is nothing to indicate his involvement was more than peripheral. With appellant's pilot's license, he could have been the smuggler that brought the drugs into California and nothing more. It is also possible that appellant was simply a courier supplying Calicchio with the drugs.

When faced with a similar situation, the court in Gerardo v. Commissioner, 552 F.2d 549, 554-555 (3rd Cir. 1977), wrote that:

> [w]hile we realize the difficulties which the Commissioner encounters in assessing deficiencies in circumstances such as are presented here, we nevertheless must insist that the Commissioner provide some predicate evidence connecting the taxpayer to the charged activity if 'effect is to be given his presumption of correctness.

In the instant appeal, respondent has not provided that necessary connection. There is no evidence appellant sold drugs at any time. There are no known sales of narcotics other than those conducted by Calicchio. Without a solid connection to Calicchio's drug sales, appellant may not be attributed with receiving income from the sales Calicchio may have made. (Llorente v. Commissioner, supra.) Without any known sale attributable to appellant, the inference that he received income from the sales of narcotics cannot be maintained. (Llorente v. Commissioner, supra; Gerardo v. Commissioner, supra.)

In regards to the cash found in the car, there is no evidence as to when, or how, the cash was acquired. It may have been earned in a prior reporting period or have been a gift which was not taxable to appellant.

There was no investigation by respondent into the time or method used to acquire the cash. It is also unknown when, or even if, appellant purchased the cocaine found in the car. If the drugs were purchased, it is unknown when appellant acquired the money to do so. Consequently, there is no evidence to support the assumption that the cash or drugs found in the car were acquired by appellant during the appeal period. (See Lucia v. United States, supra; Willits v. Richardson, supra; Appeal of Burr McFarland Lyons, supra.) Further, respondent has not provided us with any evidence to show appellant's net worth at the beginning of the period in question. "[T]he inference of unreported income can be drawn only if, and the if is a big one, a starting, opening net worth statement is established with some reliability." (Phillips' Estate v. Commissioner, 246 F.2d 209, 213 (5th Cir. 1957).) Consequently, we cannot use the net worth method of income reconstruction to determine if the cash found in the car or the funds used to purchase the cocaine were acquired during the period in question. Accordingly, we are unable to sustain a tax on these funds as unreported income received during the appeal period.

Respondent has rested-its case on the suspicion that appellant was a drug dealer of gigantic proportions but has produced no tangible evidence to show that a single unreported taxable event occurred during the period in question. We cannot sustain respondent's action on mere suspicion. As put forth by the court in Weimerskirch v. Commissioner, 596 F.2d 358, 362 (9th Cir. 1979):

> The reason for the requirement that there must be some evidentiary foundation linking the taxpayer to the alleged income-producing activity is especially acute where, as here, the government asserts that the taxpayer was engaged in an activity which is otherwise illegal. This is particularly true when the illegal activity is not only'morally reprehensible, but also punishable by an extended prison sentence. By its allegation that a taxpayer has unreported income from the sale of narcotics, the government is affixing a label, a label which in this case.reads "[cocaine] pusher." To allow the government to do this without offering any probative evidence linking the taxpayer to the activity runs afoul of every notion of fairness in our system of law.

We find that the record is totally devoid of evidence linking appellant to any income from the sale of narcotics. Under such circumstances, the judicial authorities discussed above mandate the conclusion that respondent's assessment is arbitrary and unreasonable. Accordingly, the subject jeopardy assessment must be revetsed.

Appeal of Larry R. Maynard

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 Larry R. Maynard for reassessment of a jeopardy assessment of personal income tax in the amount of $183,854 for the period January 1, 1979, to October 13, 1979, be and the same is hereby reversed.

Done at Sacramento, California, this 4th day Of February, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

_____, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9