BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82J-1884-KP
ALAN E. FRENCH)

For Appellant: Paul J. Salcedo
Attorney at Law

For Respondent: Philip M. Farley
Counsel

OPINION

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 Alan E. French for reassessment of a jeopardy assessment of personal income tax in the amount of $2,389 for the period January 1, 1982, through July 28, 1982.

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

Appeal of Alan E. French

The issues presented by this appeal are whether appellant received income from the illegal sale of controlled substances and whether respondent has properly reconstructed appellant's income from such drug sales to support the resulting jeopardy assessment.

During May 1982, officers of the Baldwin Park Police Department received information from a confidential informant that he and the appellant had recently been trafficking in cocaine. The informant further stated that appellant was still heavily involved in the drug trade and was the second person down from the top of a cocaine distribution ring.

This information resulted in a two-month surveillance of appellant's residence. During that period, a large number of people were observed entering appellant's home, staying a few minutes, and leaving. Subsequently, appellant's previous landlord informed the police that a similar pattern of traffic occurred at appellant's prior residence during the two years appellant rented from him. As a result of this information, a search warrant of appellant's trash was issued. The search revealed several large plastic bags, trace amounts of cocaine, and stems of marijuana. These discoveries led to the issuance of a search warrant of appellant's residence. The subsequent execution of that warrant resulted in the seizure of 13.7 grams of cocaine, 250.5 grams of marijuana, 245.3 grams of hashish, several ledgers documenting drug sales, various handguns and rifles, a 100-oz. silver bar, a gram scale, and $2,556.36 in cash.

Appellant was arrested during the raid and was advised of his constitutional rights. Appellant waived his rights and admitted to the arresting officers that he had been involved in the drug trade for over four years. As the raid was being conducted, several individuals appeared at appellant's residence to buy or sell drugs. During the same period, several incoming phone calls were monitored in which the callers attempted to buy or sell narcotics.

Shortly after appellant's arrest, respondent was informed of the above events. As a result of the information provided by the police, respondent determined that appellant was involved in the sale of controlled substances and that his sales had resulted in unreported, taxable income for the period of January 1, 1982, through July 28, 1982. Based upon the search warrants, the

evidence seized, appellant's admission, and the arrest reports, respondent estimated appellant's unreported income to be $33,450 for the period in question. Believing that the collection of the tax on that amount was in jeopardy, respondent issued a jeopardy assessment for $2,389: An order to withhold the money seized in the raid was issued. Thereafter, appellant requested a reassessment of respondent's determination but failed to cooperate with respondent's request for information regarding his finances. Accordingly, respondent affirmed its jeopardy assessment and this appeal followed.

The initial question presented by this appeal is whether appellant received any income from the illegal sale of narcotics during the period at issue. Upon receiving information that appellant was illegally selling drugs, the police began their surveillance of his home. Over a two-month period, police officers observed many different individuals entering appellant's residence, staying a few minutes, and leaving, a pattern of visitation that indicates the resident is involved in the drug trade. (Appeal of Gregory Flores, Sr., Cal. St. Bd. of Equal., Aug. 1, 1984.) A search of appellant's trash revealed trace amounts of cocaine and marijuana. Finally, the raid upon appellant's house uncovered drugs, ledgers containing records of drug sales, guns, packaging materials, and other indications of appellant's involvement in the drug trade. During the raid, appellant admitted he had been involved in the drug trade for four years. This evidence clearly establishes at least a prima facie case that appellant was illegally selling cocaine.

Appellant contends that a jeopardy assessment cannot be supported by these facts because a procedural defect in the seizure of much of the above-described evidence resulted in the suppression of that evidence and the dismissal of all of the pending criminal charges. Appellant apparently believes that since the evidence seized by the police was suppressed during appellant's criminal proceeding, this board may not consider that evidence in determining whether appellant was engaged in the illegal sale of narcotics.. Appellant is mistaken.

Respondent may adequately carry its burden of proof that a taxpayer received unreported income through a prima facie showing of illegal activity by the taxpayer. (Hall v. Franchise Tax Board, 244 Cal.App.2d 843 [53 Cal.Rptr. 597] (1966); Appeal of Richard E. and Belle Hummel, formerly Belle McLane, Cal. St. Bd. of Equal., Mar. 8, 1976.) The fact that the criminal charges

against appellant were dismissed does not indicate that the illegal activity did not occur, only that the occurrence of the illegal activity could not be proven in a criminal case by admissible evidence beyond a reasonable doubt. Further, as an administrative body we are allowed to consider the whole record surrounding a case, not just evidence that would be admissible in court. (Appeal of Alfred M. Salas and Betty Lee Reyes, Cal. St. Bd. of Equal., Feb. 28, 1984; Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.) This consideration may even include evidence that is illegally obtained by the police. (Appeal of Carmine T. Prenesti, Cal. St. Bd. of Equal., Apr. 9, 1985; Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal., July 29, 1981;) Accordingly, a conviction is not required to support the conclusion that a prima facie case has been established that a taxpayer received unreported income from an illegal activity. (Appeal of Carl E. Adams, Cal. St. Bd. of Equal., Mar. 1, 1983.)

The second issue on appeal is whether respondent properly reconstructed the amount of appellant's income from drug sales. Under the California Personal Income Tax Law, a taxpayer is required to specifically state the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) Gross income is defined to include "all income from whatever source derived," unless otherwise provided in the law. (Rev. & Tax. Code, § 17071.) It is well established that any gain from the illegal sale of narcotics constitutes gross income. (Farina v. McMahon, 2 A.F.T.R.2d (P-H) ¶ 58-5246 (1958).)

Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. § 1.446-1(a)(4); former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25, 1981 (Register 81, No. 26).) In the absence of such records, the taxing agency is authorized to compute a taxpayer's income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17651, subd. (b); I.R.C. § 446(b).) The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is not required. (Harbin v. Commissioner, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct and the taxpayer bears the burden of proving it is erroneous.

(Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, supra.)

Because of the difficulty in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., Shades Ridge Holding Co., Inc. v. Commissioner, ¶ 64,275 T.C.M. (P-H) (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has been recognized that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to ensure that such a reconstruction of income does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board require that each element of the reconstruction be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Appeal of Burr McFarland Lyons, supra.) 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 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr McFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., Mar. 8, 1976.)

In the instant appeal, respondent relied upon information resulting from the police investigation of appellant's activities and from evidence obtained in his residence in reconstructing the appellant's income by the projection method. Specifically, respondent determined that (i) appellant was engaged in the sale of narcotics; (ii) appellant had been engaged in the sale of drugs since at least January 1, 1982, through July 28, 1982; and (iii) appellant had sold over $33,000 worth of drugs during that period.

We have discussed above whether there was a basis for respondent's conclusion that appellant was involved with the illegal sale of drugs. Appellant attempts to discredit the evidence provided by the

confidential informant as being "stale." We note that information from an untested confidential informant will be considered reliable if the information that he supplies proves to be accurate and ultimately results in the seizure of narcotics and appellant's arrest. (See Appeals of Siroos Ghazali, Cal. St. Bd. of Equal., Apr. 9, 1985; Appeal of Clarence Lewis Randle, Jr., Cal. St. Bd. of Equal., Dec. 7, 1982.) As stated above, a conviction is not required to support the conclusion that a prima facie case has been established that a taxpayer received unreported income from an illegal activity. (Appeal of Carl E. Adams, supra.) Accordingly, due to the seizure of drugs at appellant's residence and his subsequent arrest, respondent's conclusion that appellant was involved in selling drugs is not based upon conjecture.

The second assumption in respondent's reconstruction formula was that appellant had been dealing narcotics during the period in question. Appellant admitted to the police during the raid on his residence that he had been selling narcotics for over four years. Further, appellant's prior landlord stated that the pattern of traffic to and from appellant's prior residence corresponded with the pattern of traffic observed by the police at appellant's new residence just before appellant's arrest. Even with this evidence, respondent chose to limit appellant's liability to the period January 1, 1982, to July 28, 1982.

Appellant now contends that he never stated that he had been in the drug trade for the past four years. Further, appellant attacks his prior landlord's information as being "too vague."

Appellant's admission was recorded in the police report of the raid on appellant's house. We have previously held that police reports are credible evidence. (See, e.g., Appeals of Alfred M. Salas and Betty Lee Reyes, supra; Appeals of Manual Lopez Chaidez and Miriam Chaidez, Cal. St. Bd. of Equal., Jan. 3, 1983.) As stated above, the technical rules of evidence do not preclude our consideration of the entire record for purposes of deciding these appeals. (Appeal of Marcel C. Robles, supra.) While these reports are hearsay, they are nonetheless admissible evidence in a proceeding before this board. (Appeal of David Leon-Rose, supra; see also Cal. Admin. Code, tit. 18, reg. 5035, subd. (c).) In comparing appellant's statement recorded at the time of his arrest with his claim made during this appeal, we find his self-serving disclaimer on appeal less than

persuasive. Further, while the landlord's statement by itself may not have carried sufficient weight to support this assessment on its own, when considered with the rest of the record, the landlord's statement supports the overall picture that appellant had been involved in selling illegal drugs for some time. Accordingly, we find that respondent has sufficient evidence to support its conclusion that appellant had been dealing drugs since at least January 1, 1982.

The third assumption in respondent's reconstruction formula was that appellant had sold drugs worth more than $33,000 during the above-stated period. This figure was arrived at by the use of information obtained from the search warrants, the evidence seized, appellant's admission, and the arrest reports.

While not specifically defending the figure used in its assessment, respondent argues that the facts of this case would support a much larger assessment. Respondent points to the fact that appellant was arrested with drugs valued at $3,124 in his residence. It is "reasonable to assume that a dealer would only have on hand the amount of drugs which could easily and quickly be disposed of.* (Appeal of Clarence P. Gonder, Cal. St. Bd. of Equal., May 15, 1974.) Further, we have previously found an inventory turnover rate of once a week to be reasonable. (See, e.g., Appeal of Gregory Flores, Sr., supra.) Therefore, as respondent argues, the evidence obtained during appellant's arrest could support a finding that appellant had a gross income of almost $94,000 during the appeal period, three times respondent's present determination. Thus, respondent's present assessment is less than one-third of what could be assessed. We find nothing in the record to contradict this projection. Consequently, we find that there is evidence to support respondent's conclusion that appellant received over $33,000 in unreported income during the period in question.

Finally, appellant presents two closing contentions. First, appellant argues that respondent failed to take his full financial picture into account when it developed its projection. Specifically, respondent failed to take into account an alleged business loss sustained by appellant in 1982. Secondly, appellant argues that respondent does not have the right to hold some of the funds seized during the police raid to ensure the satisfaction of his tax liability because part of the impounded money was not his.

In an effort to prove his claimed business losses, appellant, for the first time during the processing of his case, presents us with a series of photocopied ledger sheets which he claims are accurate financial records of his car repair business. Upon close scrutiny of those documents, we are unable to conclude that the evidence presented by appellant satisfies his burden of proof that he is entitled to the claimed deductions. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 (78 L.Ed. 1348] (1934).)

There are several factors which cast doubt upon the credibility of the records. First, the rent payments recorded on the ledger sheets for April, May, and June 1982, do not correspond with the rent agreement described in an unlawful detainer action filed against appellant in August 1982. Secondly, appellant claims to have been disabled in 1981 to the point that he could only "supervise and manage the business." (App. Reply Br. at 9.) Yet, the ledger sheets do not list any employee salary expenses for the period in question. Without salary expenses, there would appear to be no employees to supervise. Finally; most of the payments that appellant made in his business were paid in cash without a receipt being given in exchange, a fact which makes verification of the payments difficult. Consequently, we do not find appellant's evidence persuasive. Accordingly, appellant has failed to sustain his burden of proving that respondent should consider his purported business losses in its jeopardy assessment.

Lastly, respondent has the power to collect any funds held by any governmental agency in California which belong to a taxpayer if it determines that the taxpayer has an unpaid tax liability. (Rev. & Tax. Code, § 18817; see also Horack v. Franchise Tax Board, 18 Cal.App.3d 363 [95 Cal.Rptr. 7171 (1971).) Appellant's contention that respondent's receipt of the funds used to satisfy the jeopardy assessment was improper is not reviewable by this board. (See Appeal of Bruce James Wilkins, Cal. St. Bd. of Equal., May 4, 1983; Appeals of Manuel Lopez Chaidez and Miriam Chaidez, supra.) Our only consideration on appeal is the propriety of the deficiency actually determined by respondent for the period of assessment. (Appeal of Karen Tomka, Cal. St. Bd. of Equal., May 19, 1981.) Appellant must look elsewhere to satisfy this grievance, although we note that there is little support for appellant's position as no third party claim has ever been filed and the only evidence presented by appellant is a handwritten note of unknown origin.

In summary, we find that respondent's projection of appellant's income from the illegal sale of cocaine for the period in question is reasonable when scrutinized against the record on appeal. Given that appellant has the burden of proving that the reconstruction of his income was erroneous and has failed to present evidence to support his claim, we must conclude that respondent properly reconstructed appellant's income for that period. Accordingly, respondent's action in this matter must be sustained.

Appeal of Alan E. French

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 Alan E. French for reassessment of a jeopardy assessment of personal income tax in the amount of $2,389 for the period January 1, 1982, through July 28, 1982, be and the same is hereby sustained.

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

Richard Nevins , Chairman

Conway H. Collis , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

, Member

*For Kenneth Cory, per Government Code section 7.9