BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82J-1861-KP
DENNIS AND CYNTHIA ARNOLD)

For Appellants: David R. Reed
Attorney at Law

For Respondent: Kendall E. Kinyon
Assistant Chief 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 Dennis and Cynthia Arnold for reassessment of jeopardy assessments of personal income and penalties as follows:

	Year or Period	Amount
Dennis and Cynthia Arnold	1978	$11,819.85*
Dennis Arnold	1979	467.50"
	1/1/80 to 5/1/80	41049.00
Cynthia Arnold	1979	467.50*
	1/1/80 to 5/1/80	4,049.00

* Includes penalties.

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

Appeal of Dennis and Cynthia Arnold

The issue on appeal is whether respondent's reconstructions of appellants' income for the years at issue are supported by the evidence presented on appeal.

On April 30, 1980, a confidential reliable informant advised the San Mateo Sheriff's Department that an individual had placed $5,000 in a brown valise and was planning to use that money to purchase methamphetamine from appellants. Sheriff's officers followed the individual and saw him stop at appellants* residence for approximately 10 minutes. After the individual drove away from appellants' residence, sheriff's officers stopped him, searched his car, and found the above-described valise. The valise contained methamphetamine, but there was no cash as reportedly seen by the informant. A search warrant of appellants' residence was obtained and the ensuing search revealed 2.08 pounds of methamphetamine and a total of $55,800 in cash. As a result of that search, Mr. Arnold admitted that he sold narcotics in 1980. Appellants were subsequently arrested, and Mr. Arnold was eventually sentenced to prison,

Upon receipt of the above information, respondent determined that appellants had received unreported income for the years at issue from the illegal sale of narcotics. Respondent proceeded to reconstruct appellants' income for that period and, determining that the collection of the appropriate taxes would be jeopardized by delay, issued jeopardy assessments. In reconstructing appellants' 1978 income, respondent determined that they failed to report as income for that year $100,000 that they transferred towards the purchase of real property. In regard to 1979, respondent determined that appellants had failed to file an income tax return for that year. Therefore, respondent estimated that appellants spent $1,500 a month on living expenses for that.year, and included as income $6,000 from the sale of a tractor which was evidenced by a receipt dated that year and discovered during the sheriff's raid. The 1980 assessment was based upon the cash and the cost to appellants of the methamphetamine found during the raid, a $2,000 cash purchase of a spa, and the same cost of living expenses as assumed in 1979, $1,500 per month. For 1978, respondent assessed a negligence penalty. For 1979, respondent assessed a.negligence penalty and a penalty for the failure to file a tax return. Appellants filed a petition for reassessment, which was denied, and this appeal followed.

Appellants have presented no argument as to why we should' reverse the imposition of the penalties in question. The burden of proving that a negligence or failure to file penalty should not be imposed is upon the taxpayer, and where the taxpayer offers no evidence to show why the penalties should not be imposed, we must assume that they apply. (Appeal of Woodview Properties, Inc., Cal. St. Bd. of Equal., Oct. 10, 1984; Appeal of Edward B. and Betty G. Gillespie, Cal. St. Bd. of Equal., Oct. 27, 1981.) Consequently, the only question presented by this appeal is whether respondent properly reconstructed appellants* income for the years at issue.

Under the California Personal Income Tax Law, a taxpayer is required to state the items of his gross income during the taxable year. (Rev. & Tax. Code, § 18401.) Except as otherwise provided by law, gross income is defined to include "all income from whatever source derived" (Rev. & Tax. Code, § 170711, and it is well established that any gain from the 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, and 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; I.R.C. § 446.) Where a taxpayer fails to maintain the proper records, an approximation of net income is justified even if the calculation is not exact. (Appeal of Siroos Ghazali, Cal. St. Bd. of Equal., Apr. 9, 1985.) Furthermore, the existence of unreported income may be demonstrated by any practical method of proof that is available and it is the taxpayer's burden of proving that a reasonable *reconstruction* of income is erroneous. (Appeal of Marcel Robles, Cal. St. Bd. of Equal., June 28, 1979.)

Part of the assessments in question were based on estimates derived from the cash expenditure method of reconstructing income, a variation of the net worth method. Both of these methods are used to indirectly prove the receipt of unreported taxable income. (Appeal of Fred Dale Stegman, Cal. St. Bd. of Equal., Jan. 8, 1985.) The net worth method involves ascertaining a taxpayer's net worth at the beginning and end of a tax period. If a taxpayer's net worth has increased during that period, the taxpayer's nondeductible expenditures, including living expenses, are added to the increase and

if that amount cannot be accounted for by his reported income plus his nontaxable income, it is assumed to represent unreported taxable income. The cash expenditure method may be used when the taxpayer spends unreported income rather than accumulating it. (Appeal of Fred Dale Stegman, supra.) In such a case, the government estimates unreported taxable income by ascertaining what portion of the money spent during the tax period is not attributable to resources on hand at the beginning of the period, to nontaxable receipts, and to reported income received during that period. (See Holland v. United States, 348 U.S. 121 [99 L.Ed. 150] (1954); Taglianetti v. United States, 398 F.2d 558 (1st Cir. 1968).)

The use of the net worth method and the cash expenditure method has been approved by the United States Supreme Court. (Holland v. United States, supra; United States v. Johnson, 319u.S. 503 [87 L.Ed. 1546] (1943).) In Holland, a criminal action involving the net worth method, the court, recognizing that the use of that method placed the taxpayer at a distinct disadvantage, established certain safeguards to minimize the danger for the innocent. One of these is the requirement that the government establish "with reasonable certainty ... an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets." (Holland v. United States, supra, 348 U.S. at 132.) The holding of Hollandeen extended to cases involving the cash expenditure method. (Dupree v. United States, 218 F.2d 781 (5th Cir. 1955).) It has also been held to apply to civil cases in which the burden of proof is on the taxpayer rather than the government. (Thomas v. Commissioner, 223 F.2d 83, 86 (6th Cir. 1955).) In such cases, the burden of proof remains on the taxpayer, but the record must contain at least some proof which "makes clear the extent of any contribution which beginning resources or a diminution of resources over time could have made to expenditures." (Taglianetti v. United States, supra, 398 F.2d at 565.) If such proof is lacking, the government's determinations are arbitrary and cannot be sustained. (Taglianetti v. United States, supra; Thomas v. Commissioner, supra.)

Respondent based its assessment for 1978 on the belief that appellants were selling narcotics during that year and that the funds used for the down payment on a parcel of real property came from those sales. Whether appellants were in the drug trade in 1978 is not the issue. Respondent's reconstruction of income for that

year by means of the cash expenditure method is flawed by its lack of evidence as to appellants' opening net worth. (See Taglianetti v. United States, supra.) There has been no evidence presented to indicate appellants' financial worth as of January 1, 1978, even as to income they may have had prior to the years at issue. The only indication of appellants' income and opening net worth is what they declared on their tax return in 1978. This knowledge of one year's income does not, however, give us any insight into appellants' overall financial picture prior to or during the years at issue. 2/ Consequently,

2/ While we agree with respondent that the cash expenditure method of income reconstruction does not require the same exactness as the net worth method requires in determining the opening balance of a taxpayer, this case does not present the necessary facts that make clear the extent of any contribution which beginning resources or a diminution of resources over time could have made to expenditures. (Taglianetti v. United States, supra.) In constrast, the United States Supreme Court in Holland v. United States, supra, approved of the jury's decision that the taxpayers must have made the expenditures in question from current unreported income as the taxpayer's dismal financial situation over the prior 20 years negated any possibility that they had accumulated assets sufficient to account for any of the current expenditures. The court also approved a finding in Friedberg v. United States, 348 U.S. 142 [99 L.Ed. 188] (1954), that the taxpayer could not have accumulated $60,000 in a hidden cache when he filed no tax returns for the prior 10 years, admitted to earning only $50 a week, and had been unable to keep his $30-a-month mortgage current. Lower federal courts have approved even less restrictive methods of determining an opening balance: borrowing of funds and low reported income during the six years prior to the years at issue contradicted taxpayer's claim of a large cache built up in earlier years (Thomas v. Commissioner, supra); the finder-of-fact exam-he prior 20 years' tax returns and determined that at most the taxpayer could have accumulated $28,000 (Hoffman v. Commissioner, 298 F.2d 784 (3d Cir. 1962)); failure to file tax returns for the four years before the appeal year allowed the trier-of-fact to assume that the taxpayer's net worth at the beginning of the appeal year was zero. (Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1949).) The common factor in all of the above-cited decisions is that the finder-of-fact had some knowledge

(Continued on next page.)

if we had to depend solely on the cash expenditure method to reconstruct appellants' income for 1978, we could not find that the $100,000 constituted unreported income for that year.

While this failure to establish an opening net worth would normally end our inquiry in appellants' favor, respondent has established, through a series of admissions by Mr. Arnold, that appellants had at least $94,000 in unreported income in 1978. Apparently, appellants felt that by presenting an explanation to contradict respondent's determination as to the source of the $100,000, they would somehow discredit respondent's determination. Appellants were mistaken. It 'is of little consequence how a taxpayer acquired the unreported income as long as it has been shown that the income was acquired from taxable sources during the year at issue. (See Holland v. United States, supra.) During the protest phase of their appeal, Mr. Arnold stated that the money for the down payment on the property did not come from the illegal sale of drugs but from other sources, to wit: $3,000 allegedly paid to Mr. Arnold for his work as a mechanic in 1978; $41,000 in exchange for the forgiveness of alleged gambling debts incurred.in 1978 by the seller; and an offset of an additional $50,000 for labor allegedly performed by Mr. Arnold for the seller during 1978, Furthermore, appellants reported $25,043 as income on their 1978 tax return and have not presented proof that any of the items listed above were included in the reported income. Consequently, respondent's determination that appellants earned unreported income in 1978 is confirmed, to the extent of $94,000, by appellants' admissions.

We note, however, that as to the final $6,000 of respondent's original 1978 estimate of income, there is nothing to contradict appellants' claim that that sum was accumulated through gambling winnings in 1977. Without an opening balance or an admission that they earned that money in 1978, we are unable to conclude that the $6,000 was income taxable in 1978.

2/ (Continued)
of the taxpayer's past financial situation that allowed it to deduce-the taxpayer's financial condition at the beginning of the appeal year. As stated above, there is no such evidence presented in the case before us.

In the same vein, we are compelled to disagree with respondent's determinations for the years 1979 and 1980 wherein respondent determined that appellants had monthly living expenses of $1,500 and that they purchased a spa in 1980 for $2,000 cash allegedly obtained from unreported income that year. As stated above, the cash expenditure method of reconstruction requires the establishment of the opening net worth of a tax period to validate the income estimation (Holland v. United States, supra; Taglianetti v. United States, supra), and in this case no opening balance has been established with any certainty for any of the years in question. Consequently, the assessments for 1979 and 1980 must be modified to exclude the alleged monthly living expenses of $1,500 and the purchase of the spa, as there is nothing to show that the alleged expenses were paid out of current unreported income.

The balance of respondent's 1979 income estimate was based on the sale of a tractor which was evidenced by a receipt of sale. Respondent determined that appellants should have reported the sale proceeds as income for 1979 and that they should have reported the sale as ordinary income. Respondent's determination is presumptively correct and it is appellants' burden to prove otherwise. (Appeal of Peter M. and Anita B. Berk, Cal. St. Bd. of Equal., June 27, 1984.) Appellants have offered no argument to refute this finding. Consequently, respondent's determination that appellants received $6,000 in ordinary income in 1979 from the sale of the tractor must be upheld.

We next consider the final elements of respondent's income reconstruction for 1980. As we discussed above in regard to the 1978 assessment, respondent's inclusion of the $55,800 cash and the cost of the methamphetamine in appellants' 1980 income would ordinarily fail for lack of an opening net worth. Once again, however, appellants have provided support for respondent's determination by a series of admissions. In response to the 1980 assessment, appellants have argued that the drugs and cash were not income to them as they were simply holding the money and the drugs for their supplier. Appellants have refused, however, to produce evidence supporting their contention, allegedly out of "fear for their lives." Without evidence to support this contention, we do not find this explanation persuasive. Mr. Arnold has admitted that the $55,800 represented sales of methamphetamine he made during 1980. Furthermore, Mr. Arnold has stated that his supplier advanced him the

methamphetamine during the same year, and that appellants were expected to repay the advance from the sale of the narcotics. As appellants have admitted to receiving that income in 1980 and have not supplied us with any persuasive evidence that they were mere bailees of the drugs and money, they have not satisfied their burden of proving that the income was not taxable as 1980 income. (See Appeal of Marcel C. Robles, supra.) Consequently, respondent was correct in including the cash and the wholesale price of the drugs in appellants' 1980 income.

Appellants' final argument that respondent overstated their 1980 income by erroneously failing to allow a deduction for the cost of the goods sold is mistaken. Arguments similar to appellants' have been consistently rejected by this board. (See e.g., Appeal of Gregory Flores, Sr., Cal. St. Bd. of Equal., Aug. 1, 1984; Appeal of Alfred M. Salas and Betty Lee Reyes, Cal. St. Bd. of Equal., Feb. 28, 1984.) For taxable years which have not been closed by a statute of limitations, such as the years presently before us, no deduction for cost of goods sold from illegal sales of controlled substances is allowed. (Rev. & Tax. Code, § 17297.5.)

In summary, we find respondent's reconstruction of appellants' unreported income for the period in question to be supported by the record on appeal except to the extent that respondent determined: (1) that appellants' monthly living expenses were paid out of unreported income obtained during the years the expenses were alleged to have occurred; (2) that appellants purchased a spa in 1980 with unreported income from that year: and, (3) that appellants had additional income of $6,000 in 1978 above their admitted unreported income. Respondent's action in this matter will be modified in accordance with this opinion.

Appeal of Dennis and Cynthia Arnold

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 Dennis and Cynthia Arnold for reassessment of jeopardy assessments of personal income tax and penalties as follows:

	Year or Period	Amount
Dennis and Cynthia Arnold	1978	**$11,819.85***
Dennis Arnold	1979	**467.50***
	1/1/80 to **5/1/80**	**4,049.00**
Cynthia Arnold	1979	**467.50***
	1/1/80 to **5/1/80**	**4,049.00**

* Includes penalties.

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 6th day of May , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9