

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JOHN ELLIOTT THOMAS) **No. 82J-644-KP**

Appearances:

For Appellant: Robert L. **Nelms**
Attorney at Law

For Respondent: Philip M. Farley
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 John Elliott Thomas for reassessment of a jeopardy assessment of personal income tax in the amount of \$28,410 for the year 1979.

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

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The issue on appeal is whether respondent's reconstruction of appellant's income for the year at issue through the use of the cash expenditures method is supported by the evidence presented.

During February 1980, the Westminster Police Department searched the residence of Bernard Murphy, a suspected cocaine dealer. Among the discoveries during the raid were a ledger of Murphy's drug transactions and two personal telephone books. Many of the people listed in the telephone books were eventually linked with the narcotics sales listed in the ledger. The ledger recorded 64 separate purchases of cocaine by a man named "John," which totaled \$133,730. The sales to "John" ranged from \$675 to \$2,450 a month during the months of February through May 1979, to over \$64,000 a month in November 1979 and December 1979. The telephone books listed two "Johns," one of which was followed by appellant's telephone number.

In an attempt to determine the identity of the "John" listed in the ledger, the police began to contact other individuals listed in Murphy's drug records. Eventually, one woman identified appellant as the "John" listed in the ledger. The woman stated that she introduced appellant to Murphy so that appellant could purchase cocaine from **Murphy**. She also indicated that she had witnessed several cocaine purchases by appellant from Murphy, and had witnessed Murphy recording those transactions in the ledger seized by the police during the raid on Murphy's residence. Finally, the woman stated that she had witnessed several sales of cocaine by appellant 'to third 'parties.

Based upon this information, the police determined that the "John" listed in the ledger was appellant, and that due to the size of the purchases, appellant was also a cocaine dealer. A search warrant was obtained and executed on May 12, 1980. During the raid on appellant's residence, the police discovered over \$4,000 in cash, two cocaine test kits, marijuana, hashish, "magic mushrooms," scales, a pistol, various other items of narcotics paraphernalia, and several newspaper stories of Murphy's arrest. Further investigation revealed that appellant had various bank accounts in his name with deposits totaling over \$7,000. During his post-arrest interview, appellant admitted that the drugs found in the apartment were his but denied knowing Murphy. Appellant admitted to earning only \$600 to \$700 a month through his car repair business and the **G.I.** Bill.

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Respondent received the above information and issued a jeopardy assessment derived from the projection method of income reconstruction based upon the information contained in Murphy's ledger. Appellant filed a petition for reassessment. Appellant continued to deny receiving any income from the sale of cocaine during the time the petition was being considered. As a result of the petition, respondent lowered its assessment. Using a combination of the expenditure and projection methods of income reconstruction, respondent attributed all of Murphy's sales to "John" during 1979 to appellant. Respondent then averaged the known sales over the months listed in Murphy's ledger and then assumed that appellant was buying that average amount of cocaine over the months in which no sales were recorded. Respondent added all of the known monthly sales to the average monthly sales for the unrecorded months and arrived at a gross income projection of \$267,460 for 1979. An appropriate assessment was issued based on the revised income estimation and this appeal followed.

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, § 17071), 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 C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In this appeal, respondent used the cash expenditure method of reconstructing income, a variation of the net worth method. Both of these methods are used

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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 tax 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, 319 U.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 Holland has been 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. (Thomas v. Commissioner, supra; Taglianetti v. United States, supra.)

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In the present case, there are several assumptions made by respondent in its estimation of appellant's gross income. The first assumption is that all of the cocaine sales to "John" listed in Murphy's ledger were records of sales to appellant. This determination was based upon statements contained in the Westminster **Police's** request for a search warrant for appellant's apartment wherein a woman reportedly stated that she saw appellant buy cocaine from Murphy several times and that Murphy recorded the sales in the ledger found in the police raid on Murphy's **residence**. While police reports are hearsay, they are admissible before this board and are considered credible evidence. (Appeal of: Carl E. Adams, Cal. St. Bd. of Equal., Mar. 1, 1983.) While appellant attempts to discredit the woman's information with statements later made by her at appellant's **preliminary** hearing, we do not find his argument persuasive. It is important **to realize** that at the preliminary hearing the woman confirmed witnessing at least one three-to four-ounce sale of cocaine by Murphy to appellant. Further, the woman remembered Murphy recording the sale, although the woman did not remember the sale being recorded in the ledger. While the statements made at the preliminary hearing do not absolutely confirm the statements the **woman** had earlier given to the police, neither do the preliminary hearing comments fully contradict the prior statements given to the police. Furthermore, to the extent that they may contradict the earlier statements, when we consider her faulty memory and evasive answers at the preliminary hearing, we find the police report's recordation of the woman's knowledge of Murphy's operation a more believable piece of evidence. Thus, we find that there is sufficient credible evidence in the record to support respondent's determination that the "John" referred to in Murphy's ledger for at least some of the sales is appellant.

Although we have found that several sales to "John" in the ledger may reasonably be attributed to appellant, it does not necessarily follow that all of the sales to "John" may be assumed to have been to appellant. There were two Johns listed in Murphy's telephone directory. It is reasonable to assume that since many of the persons listed in Murphy's telephone books were his customers, both Johns had purchased drugs from him. It is important to realize, however, that the primary purpose Murphy kept his records was to keep track of his inventory and to determine how much profit he made after he paid his supplier for the drugs he sold. It would appear that the only reason he would need to precisely

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record who purchased the drugs from him would be if he sold the narcotics on credit, thereby indebting the purchaser to him. If the payments were in cash, there would seem to be little need to differentiate between any of the buyers.

Upon review of Murphy's records, it is evident that none of the sales to "John" were on credit. As there is nothing in Murphy's record to indicate which John bought the narcotics and since there is no logical reason to attribute all of the sales to appellant, respondent's assumption that all of the sales of cocaine recorded in Murphy's ledger were sales to appellant cannot be supported. On the other hand, as we have found that appellant purchased some narcotics from Murphy, an assumption that none of the recorded sales were to appellant is equally unsupportable. Consequently, we find it reasonable, in light of the evidence of appellant's known drug purchases and the fact that Murphy apparently sold drugs to two Johns, that appellant be credited with conducting one-half of the total dollar amount of the drug sales to "John" recorded in Murphy's ledger. As appellant has failed to produce evidence which would prove that he conducted less than our estimate of drug sales, estimate of drug sales, let alone respondent's estimate of drug sales; he has provided no basis from which he may dispute our conclusion. (See Appeal of Roland Aranda Garcia, Cal. St. Bd. of Equal., Mar. 4, 1986; Appeal of Siroos Ghazali, supra; Appeal of David Wayne Dominici, Cal. St. Bd. of Equal., Dec. 13, 1984.)

The second assumption in respondent's estimation is that appellant was a cocaine dealer and that he purchased the cocaine for resale. In undisputed testimony at appellant's preliminary hearing, appellant's arresting police officer testified that the quantity of the purchases and the short time spans between many of the recorded sales indicated that appellant had not purchased the cocaine for personal use. This conclusion is supported by appellant's own statement that he did not use cocaine. Furthermore, the woman who witnessed appellant purchasing cocaine from Murphy, also witnessed appellant selling cocaine to several third parties. Consequently, the conclusion that the large purchases of cocaine were meant for resale and that appellant was a cocaine dealer is supported by the record. (See People v. Shipstead, 19 Cal.App.3d 58, 78 [96 Cal.Rptr. 513] (1971).)

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The third assumption in respondent's estimation is that the funds used by appellant to purchase cocaine from Murphy were obtained during the year in question and that the funds were unreported income for that year. This conclusion is based upon appellant's lack of known income to account for such massive purchases. During the police interview, appellant stated that he had a monthly income somewhere between \$600 to \$700. During the same period, his admitted monthly expenses were approximately \$400. Furthermore, appellant stated that he had lived on such a meager amount of money "all my life." (Resp. Br., Ex. C at 26.) We find it inconceivable that a **26-year-old** man who was attending college and living on \$700 a month could save the thousands of dollars represented by the cocaine sales recorded in Murphy's ledger, or even the \$11,000 in cash and bank deposits found at the time of appellant's **arrest**, by 1979. (See Holland v. United States, supra.) Consequently, we find it reasonable to assume that appellant did not have a large amount of cash prior to his known purchases of narcotics and that he obtained the money represented by the recorded sales in Murphy's records from the resale of cocaine during 1979. (See Holland v. United States, supra.)

Finally, during its investigation, respondent discovered a gap in appellant's purchases from Murphy from June to October 1979. Respondent attempted to attribute further cocaine purchases by appellant during that gap by taking an average of appellant's known purchases in 1979 divided by the number of months he was known to have purchased cocaine from Murphy. Respondent then assumed appellant purchased that average amount of cocaine during the months in which no sales were recorded. Respondent then added all of the assumed monthly purchases to the known sales and arrived at its estimate of appellant's unreported gross income.

We cannot approve **of this** method of reconstructing appellant's income for the unrecorded months. The cost expenditure method of reconstruction is based upon known expenditures by a taxpayer that cannot be explained from known assets and income. (Taglianetti v. United States, supra,) The only known connections between appellant and any purchases of cocaine are the recorded sales in Murphy's ledger. Respondent asks us to assume that there were more expenditures than are recorded. Such an assumption clearly violates the premise upon which the cost expenditure method of income reconstruction is predicated. (See Taglianetti v. United States, supra.) Accordingly, we find that the correct measure of

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appellant's unreported income for 1979 must be based only on cocaine purchases actually recorded in Murphy's ledger.

In summary, we find that respondent has **produced** adequate evidence **to support** the determination that appellant received unreported income during the appeal year in the amount of one-half of the dollar amount of cocaine purchases recorded **under**, the name of "John" in the drug dealer's ledger. We find that respondent has not produced sufficient evidence to support its determination that appellant received unreported income during those months in 1979 for which there were no recorded purchases by "John." Consequently, respondent's action in this matter must be modified in accordance with this opinion.

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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 John Elliott Thomas for reassessment of a jeopardy assessment of personal income tax in the **amount of \$28,410** for the year **1979, 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 **10th** day of June , **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