BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81R-1119-SW
GLEN ALEXANDER)

Appearances:

For Appellant: Glen Alexander, in pro. per.

For Respondent: Philip M. Farley Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Glen Alexander for refund of personal income tax in the amount of $9,012 for the period January 1, 1980 to August 18, 1980.

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 Glen Alexander

The issue presented in this appeal is whether respondent properly reconstructed the amount of appellant's income for the period January 1, 1980, through August 18, 1980.

On February 4, 1980, Officer R. Berendsen of the Concord Police Department received a telephone call from an unidentified female juvenile informing him that an individual named "Alex" was selling drugs at Cambridge Park. The same juvenile later called back and stated that the seller's full name was Glen Alexander. On June 25, 1980, Officer Berendsen received a telephone call from a second unknown female providing similar information. He also received calls from a male neighbor of appellant who claimed that 50 to 75 people per day were visiting appellant and that something had to be done about the traffic at the house. As a result of these calls, appellant's home at 1498 Sunshine Drive, Concord, California, was placed under surveillance. The results of these surveillances were as follows:

Date	Hours of Surveillance	Number of Persons Entering and Leaving Appellant's Home
June 25, 1980	2	18
June 26, 1980	8	37
June 27, 1980	4	26
July 28, 1980	3	19

On June 26, 1980, a confidential informant (CI), working with undercover officers of the Concord Police Department, called appellant and asked if appellant would sell her quaaludes and "Black Beauties." Appellant advised the CI that the price for the quaaludes would be $4.00 each and the "Black Beauties" $.50 each. Undercover officers then fitted the CI with a transmitting device, and together they drove to appellant's house. The CI entered appellant's home, purchased the drugs, and then turned the purchases over the the undercover officers. Laboratory analysis confirmed the identity of the quaaludes. The other tablets were determined not to be narcotics, The conversation between appellant and the CI was monitored by, and recorded by, the undercover officer.

On June 30, 1980, the same confidential informant arranged with Officer Berendsen to make another purchase from appellant. This time the informant, again outfitted with a body transmitter and accompanied by

members of the Concord Police Department, purchased 10 quaaludes. The drugs were then turned over to the police who confirmed the drugs' identity. A third purchase, involving the same procedure, was made on July 28, 1980, and a similar purchase was made on August 13, 1980.

Appellant was arrested on August 19, 1980, when he sold a quarter pound of cocaine to members of the United States Drug Enforcement Administration, the Pittsburg Police Department, and the Concord Police Department, all of whom were acting undercover. A subsequent search of appellant's home revealed that appellant had 32 grams of cocaine valued at approximately $2,300, plastic bags of marijuana, various drug paraphernalia and $4,923 in United States currency. As a result of this arrest, appellant was convicted on May 11, 1981, in federal court of conspiracy to distribute cocaine, distribution of cocaine, and possession with the intent to distribute cocaine.

Upon being notified of appellant's arrest, respondent reviewed the records seized by the police, including the records of deposit in several bank accounts. Respondent determined that the collection'of appellant's personal income tax for the period at issue would be jeopardized by delay. It was estimated that appellant's taxable income was $86,800; therefore, a jeopardy assessment was issued reflecting a net tax liability of $8,537. Pursuant to withholds on appellant's bank accounts and the Concord Police Department, the following amounts were seized:

Bank of America	$1,012.96
	903.88
Mutual Savings & Loan Association	1,697.16
Concord Police Department	4,923.00
	$8,537.00

Respondent determined appellant's taxable income in the following manner:

1.	Number of days in period:	231	
2.	Number of weeks in period:	31	
3.	Days of operation per week:	4	
4.	Total days of operation (31x4):	124	
5.	Average sales per customer: (Based upon police surveillance)		$40

6.	Average sales per day: (Based upon police surveillance and information received from neighbors)	3s
7.	Gross sales per day ($40 x 35):	$1,400
8.	Income for period ($1,450 x 124):	$173,600
9.	Less: cost of goods sold @ 50%	($86,800)
10.	Taxable income:	$86,800
11.	Tax:	$8,564
	Less: Personal Exemption Credit	(27)
	Net Tax Liability	$8,537

Appellant filed a petition for reassessment and submitted a financial statement which showed total cash receipts of $5,358.66 for the period under appeal. Respondent subsequently affirmed its assessment and appellant filed a claim for refund. This claim for refund was denied by respondent and appellant filed this timely appeal.

Appellant contends that the reconstruction of his income by respondent is excessive and that his only income from drug-related sales was the sale of mail order stimulants. He further contends that any other sales of drugs were merely occasional sales which do not indicate that he was in the business of selling drugs.

The initial question presented by this appeal is whether appellant received any income from illegal sales of narcotics during the period in question. Police reports show that numerous phone calls from unidentified juvenile females were received which indicated that appellant was selling drugs to juveniles. A neighbor of appellant's also complained of the vast number of people coming to appellant's house. Subsequently, the police put appellant's house under surveillance and documented the number of people entering and leaving appellant's house. On four separate occasions in June, July, and August of 1980, either a confidential reliable informant or undercover officers went to appellant's home and purchased various types of narcotics. At a later date, appellant was arrested for selling narcotics and was convicted in federal court of numerous drug-related crimes. These reports and appellant's subsequent conviction for selling cocaine establish at least a prima facie case that appellant received unreported income from the sale of drugs during the appeal period. As appellant has not presented credible evidence to refute this prima facie showing, we must conclude that he did receive unreported income from the sale of drugs during the appeal period..

The second issue is whether respondent properly reconstructed the amount of appellant's taxable 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.) As in the federal income tax law, gross income is defined to include "all income from whatever source derived," unless otherwise provided in the law. (Rev. & Tax. Code, § 17071; Int. Rev. Code of 1954, § 61.) 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, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available in the circumstances of the particular situation. (Davis v. United States, 226 F.2d 331, 336 (6th Cir. 1955); Appeal of Carl E. Adams, Cal. St. Bd. of Equal., Mar. 1, 1983.) 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 erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In view of the inherent difficulties 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 David Leon Rose, Cal. St. Bd. of Equal., Mar. 8, 1976.) It has also been recognized that a dilemma confronts the taxpayer whose income has been reconstructed. Since the taxpayer bears the burden of proving that the reconstruction is erroneous, the taxpayer is put in the position of having to prove that he did not receive the income so attributed. In order to ensure that the taxing authority's reconstruction does not lead to

injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565, 574 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527, 533 (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.) 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.) In essence, appellant challenges the jeopardy assessment as being arbitrary.

In this case, respondent has used the projection method to reconstruct appellant's income. Respondent relied upon the data in the files of the Concord Police Department which related to appellant's arrest on August 21, 1980, and on reports of previous police surveillance of appellant's activities. Specifically, respondent determined that appellant: (i) had been engaged in the "business" of selling narcotics since at least January 1, 1980, through August 18, 1980; (ii) sold an average of $40 worth of drugs to 35 customers each day; and (iii) had a standard cost of "goods" sold equal to 50 percent of his selling price.

The first two elements of respondent's reconstruction formula are based upon the independent and corroborating statements of two informants and a neighbor of appellant's. All of these individuals independently stated that appellant was selling narcotics to a vast number of individuals from his home. The first report came from an unidentified female on February 4, 1980, who stated that appellant was selling drugs to kids. A similar call was received on June 25, 1980. These calls were supplemented by calls from a male neighbor who complained about the heavy traffic and dealing at appellant's house. An informant, working with undercover police officers, purchased ten quaaludes for $4 each from appellant on June 26, 1980. Later, this same informant made a second purchase from appellant, again for $40 on June 30, 1980. On July 28, 1980, this same informant,

along with an undercover police officer, made a third purchase from appellant totalling $45. On all three occasions, the informant was outfitted with a body transmitter so that the police could monitor the sales. Finally, on August 19, 1980, appellant made a $9,200 sale of a quarter pound of cocaine to undercover police officers which resulted in his arrest. We believe that the statements of these individuals are credible and that they support the reasonableness of respondent's reconstruction formula. Moreover, we note that there exists established authority for reliance upon data acquired from informants to reconstruct a taxpayer's income from illegal activities, provided that there do not exist "substantial doubts" as to the informant's reliability. (Cf. Nolan v. United States, 49 A.F.T.R.2d (P-H) ¶ 82-941 (1982); see also Appeal of Clarence Lewis Randle, Jr., Cal. St. Bd. of Equal., Dec. 7, 1982.) The record of this appeal provides no basis for finding that any of the informants were unreliable.

In addition to the statements made by the above-mentioned informants, respondent also relied upon the items seized from appellant's house pursuant to a valid search warrant. Various narcotics and related drug paraphernalia were seized. Respondent also reviewed appellant's bank records and compared the 1979 deposits to the 1980 deposits. Appellant was employed in 1979, but had no employment in 1980. Yet in 1980, appellant continued to make deposits in varying amounts every few days. These deposits were as large as $1,252 or as small as $37. In sum, the first two elements relied upon by respondent are reasonable.

The final element in the reconstruction formula concerns respondent's determination that appellant's cost of cocaine was equal to 50 percent of his selling price. Although in previous cases respondent has allowed taxpayers engaged in the illegal sale of controlled substances to deduct the cost of "goods" sold from gross sales to arrive at their taxable income, this deduction is now statutorily prohibited. Section 17297.5, effective September 14, 1982, provides, in pertinent part, as follows:

> (a) In computing taxable income, no deductions (including deductions for cost of goods sold) shall be allowed to any taxpayer on any of his or her gross income directly derived from illegal activities as defined in Chapter 4 (commencing with Section 211) of Title 8 of,

> Chapter 8 (commencing with Section 314) of Title 9 of, or Chapter 2 (commencing with Section 314) of Title 9 of, or Chapter 2 (commencing with Section 459), Chapter 4 (commencing with Section 484), or Chapter 5 (commencing with Section 503) of Title 13 of, Part 1 of the Penal Code, or as defined in Chapter 6 (commencing with Section 11350) of Division 10 of the Health and Safety Code; nor shall any deductions be allowed to any taxpayer on any of his or her gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, those illegal activities.
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> (c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.

The sale of controlled substances, including cocaine, constitutes an illegal activity as defined by chapter 6 of division 10 of the Health and Safety Code. (Health & Saf. Code, § 11350 et seq.) Accordingly, no deduction for appellant's cost of "goods" sold is allowable. Consequently, appellant's taxable income has been understated by $86,800.

The conclusion that the reconstruction is reasonable does not end our inquiry. Appellant may still prevail if he can prove, by a preponderance of the evidence, that the assessment was erroneous. (Appeal of Peter 0. and Sharon J. Stohrer, Cal. St. Bd. of Equal., Dec. 15, 1976.) The phrase "preponderance of the evidence" means "such evidence as, when weighed with that opposed *to* it, has more convincing force, and from which it results that the greater probability of truth lies therein." (In re Corey, 230 Cal.App.2d 813, 823 [41 Cal.Rptr. 379] (1964).)

After carefully reviewing the record, we must conclude that appellant has failed to provide the evidence needed to show that the reconstruction was erroneous. The record shows that appellant was convicted in federal court of the drug charges brought against him. (See Appeal of Kenneth E. Sayne, Cal. St. Bd. of Equal., May 4,

1983.) Appellant has asserted that the cash found in his home was his savings from prior employment and that he made his income from the sale of mail order stimulants. However, these assertions have not been documented in any way, Without further evidence, it cannot be concluded that appellant's income was based on anything other than the sale of narcotics. In sum, we conclude that the reconstruction of appellant's income has a foundation in fact and is not arbitrary or unreasonable, and that appellant has failed to prove, by a preponderance of the evidence, that the jeopardy assessment was erroneous. Respondent's action in denying the claim for refund, therefore, will be sustained.