

Appeal of Gayle A. Jackson

The issues presented by this appeal are whether appellant received unreported income from the illegal sales of narcotics during the appeal period, and, if so, whether respondent properly reconstructed the amount of that income.

Appellant is a **44-year** old woman employed as a nursery school teacher's aide with the Los Angeles Unified School District. Sometime prior to January 1983, she purchased a three bedroom house at 2546 South **Curson** Avenue in the City of Los Angeles. During the appeal period, she resided there with her minor daughter, Tracy, **20-year** old son, Darin, and **25-year** old nephew, Henry Suttles. Appellant's husband, Ernest Jackson, was reportedly in jail during this time. While the record does not show whether or not appellant filed a return for 1984, she filed returns for the years 1982 and 1983.

On March 6, 1984, Detective Buford Roy Neie of the Narcotics Division of the Los Angeles Police Department (L.A.P.D.) received an anonymous telephone tip that Ernest Jackson was selling cocaine from the residence on South **Curson** Avenue. Detective Neie began an undercover investigation and attempted to make controlled purchases of cocaine from the house with the help of informants. At first, they were unable to find anyone **at the** house. During the week of May 20, 1984, however, Detective Neie contacted a confidential informant who had supplied him with reliable narcotics information on nine prior occasions. He provided the informant with government funds and transported him to appellant's house in an unmarked police vehicle. Once there, the informant knocked on the door **and** spoke with two men. The informant told them he wanted to buy cocaine and was sent by "Will." Both men at the house stated that they did not know anyone named Will. However, the shorter of the two, who is said to have been Darin Jackson, replied that he would sell the informant all the cocaine that he wanted if the informant would bring Will with him and it turned out that he knew Will. The informant left the premises, returned to the police unit, and advised Detective Neie of his conversation with the two men at appellant's home.

Based on the results of this undercover investigation, Detective Neie applied for issuance of a warrant to search the residence at 2546 South **Curson** Avenue and **the persons** of two men, tentatively identified as Darin Jackson and James Jackson. In his statement of probable cause, the detective added that two years earlier, on June 21, 1982, the narcotics unit received a complaint

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that Ernest Jackson **was** involved-in cocaine and heroin sales from the same address. **He** indicated that that investigation concluded with the arrest of two suspects for narcotics violations.

On May 29, 1984, Detective Neie obtained a search warrant from the Los Angeles Municipal Court. Two days later, while accompanied by other L.A.P.D. officers, he went to appellant's house to execute the warrant. On this occasion, Mrs. Jackson was at home with her son and nephew. Upon hearing the police demand for entry, appellant opened the door and was given three copies of the search warrant by the detective. The officers thereupon commenced a search of the house. In the first bedroom, said to be that of Darin Jackson, the officers discovered two rifles, live ammunition, and a brown plastic bag which contained narcotics paraphernalia used to package narcotics for sale, including **small** plastic sandwich bags, balloons, sifters, and measuring spoons.

Upon searching appellant's rear bedroom, the officers seized \$9,340 of cash in a clothes hamper, a stolen typewriter, a locked floor safe, and a spiral notebook with "pay and owe" drug sheets recording the names, dollar amounts, grams, and some dates of various ongoing narcotics transactions. The floor safe was later opened by the police and found to be empty. Another safe discovered under the kitchen sink contained motor oil. Two half-smoked marijuana cigarettes were found discarded in the hallway of the house. Outside the residence, an automobile was impounded because it was parked on the wrong side of the street and did not have a registration. The search, however, uncovered no cocaine or any other controlled substance. On conclusion of the search, appellant, her son, and nephew were arrested and booked on the felony charge of receiving stolen property. The charge against appellant was subsequently dismissed.

Soon thereafter; the Franchise Tax Board was notified of the arrests and began its own investigation to determine if appellant had received unreported, **tax-**able income from the illegal sale of controlled substances. Respondent obtained appellant's bank statements **and** deposit records and discovered that several large deposits had been made into her checking account in the past two years. Between July 20, 1982, and October 27, 1982, deposits **totalling \$30,907.68**, including a single deposit of **\$17,769.00** were **made** into appellant's account. Between August 5, 1983, and October.6, 1983, **\$28,348.44** was deposited into her checking account, including a

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\$13,000 deposit on August 25 and \$14,000 deposit on September 14.

In addition, data provided by a private real estate search company revealed that appellant was the owner of the single family residence at 2546 South **Curson** Avenue. A check with the Department of Motor Vehicles indicated that appellant recently purchased a new automobile, a 1984 Honda sedan. Respondent also reviewed her California income tax returns and noted that appellant had gross earnings of **\$9,235.50** and **\$9,141.14** in the years 1982 and 1983, respectively, from her job with the school district. In both years, appellant claimed **head-of-household** filing status, naming her daughter, Tracy, as the qualifying individual. For 1984, respondent found that appellant's employee statement of earnings disclosed gross income of \$9,141.

Based on the information received from the L.A.P.D. and the results of its own investigation, the Franchise Tax Board determined that appellant had unreported income from trafficking in narcotics. Because the pay and owe records seized from her house showed drug **sales of \$115,050** during the month of March 1984, respondent estimated that appellant had at least this amount of taxable income for the five-month period between January 1, 1984, and **May 31, 1984**. Respondent further determined that collection of the resultant \$11,010 tax would be jeopardized by a delay in assessment and, therefore, issued **a jeopardy** assessment on June 1, 1984. Pursuant to orders to withhold, respondent then collected **\$10,988.90** by levying upon appellant's bank account and the money seized by the L.A.P.D.

On June 14, 1984, appellant filed a petition for reassessment on the ground that she was not engaged in the illegal sale of narcotics. Respondent advised appellant that she would have to furnish information and documents to substantiate her claim that the assessment was erroneous and sent her a financial questionnaire to be filled out and returned to its offices. When it did **not receive the** completed questionnaire **or** any other reply from appellant, respondent affirmed its assessment. This timely appeal followed.

On appeal, appellant contends that the determination of the Franchise Tax Board that she received income from the illegal sale of narcotics is erroneous. Appellant has denied any involvement in narcotics trafficking and stated that she has no knowledge of any such

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activity occurring in her house. In rebuttal, respondent has argued that the evidence clearly establishes that appellant was engaged in drug sales and received income from those illegal transactions during the appeal period. Thus, the first question that must be resolved is whether appellant received any income from the illegal sales of narcotics during the period from January 1, 1984, until May 31, 1984.

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); Galluzzo v. Commissioner, ¶ 81,733 T.C.M. (P-H) (1981).)

In general, the existence of unreported income from illegal activities 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 absence of reliable books or records, the taxing agency is given great latitude to determine a taxpayer's taxable income by whatever method will, in its opinion, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b); Giddio v. Commissioner, 54 T.C. 1530, 1533 (1970).) While the choice as to the method of reconstruction lies with the taxing agency, the reconstruction must nevertheless be reasonable in light of all the surrounding facts and circumstances. (Schroeder v. Commissioner, 40 T.C. 30, 33 (1963).) 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 (2d Cir. 1970); Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) The taxing agency must offer a minimal foundation of substantive evidence supporting an inference that the taxpayer received income from the charged activity. (United States v. Janis, 428 U.S. 433, 441-442, (49 L.Ed.2d 1046) (1976); Weimerskirch v. Commissioner, 596 F.2d 358 (9th Cir. 1979).) Without that evidentiary foundation, minimal though it may be, an assessment will

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be found to be excessive and arbitrary even where the taxpayer is silent. (Gerardo v. Commissioner, 552 F.2d 549 (3d Cir. 1977); Jackson v. Commissioner, 73 T.C. 394 (1979).)

Upon examination of the sparse record in this appeal, we cannot find that respondent has established even a prima facie case that appellant received unreported income from illegal drug sales. (Hall v. Franchise Tax Board, 244 Cal.App.2d 843 [53 Cal.Rptr. 597] (1966); Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal., July 29, 1981.) At the outset, we observe that there is no evidence in the record that appellant made or attempted to make any drug sales. The police reports, upon which respondent has seemingly based its decision that appellant was a narcotics dealer, do not indicate that appellant was ever suspected or investigated by the L.A.P.D. for selling drugs. The anonymous telephone tip, which prompted Detective Neie to start his investigation, implicated appellant's husband, Ernest Jackson, for selling cocaine from the South Curson Avenue residence, not appellant. When he applied to the court for the search warrant, the detective also stated that it was Mr. Jackson who came under suspicion two years earlier for selling cocaine and heroin from the same address. During the investigation, the police or its agents never spoke to appellant much less obtained incriminating statements from her. The offer to sell cocaine to the informant came from a short male alleged to have been appellant's 20-year-old son. The ensuing search of appellant's house uncovered narcotics paraphernalia, a large amount of cash, and "pay-owe" sheets, but no narcotics. Appellant thus was not found in possession of any controlled substances and was never criminally charged by police authorities for any narcotics violation. In short, there is no direct evidence that appellant was engaged in the trafficking of drugs.

Here, the Franchise Tax board has relied upon circumstantial evidence in determining that appellant was a narcotics dealer. It is respondent's argument that the complaints of drug sales at the house, the son's offer to sell cocaine, and the seizure of the narcotics paraphernalia, cash, and "pay-owe" sheets establish that drug sales took place at appellant's house. Because she owned the house where this drug activity was occurring and the cash and "pay-owe" sheets were discovered in her bedroom, respondent has assumed that appellant was selling drugs.

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We believe that it was not reasonable for respondent to have made this assumption. The complaints of drug sales at the house implicated appellant's husband. Still, no controlled buys were made by the police there. Appellant's son was the one who made the offer to sell and the narcotics paraphernalia was found in his bedroom. Even though the cash and pay-owe sheets were discovered in appellant's bedroom, appellant lived in the house with her adult son and nephew, who presumably had access to her bedroom. Those items could very well have belonged to them or appellant's husband and placed in appellant's bedroom without her knowledge. Even if we were to assume that drug sales occurred at her house, there is still no evidence in the record to support an inference that appellant was conducting these sales **or received** funds from the illegal activity. For respondent to make this inference, the record must at least link appellant with some tax-generating acts, such as the purchase or sale of controlled substances; a mere peripheral contact with illegal conduct, such as here, is insufficient. (Llorente v. Commissioner, 649 **F.2d** 152, 156 (2d Cir. 1981).) Without some probative evidence linking appellant to the illegal sale of drugs, we cannot attribute to appellant any income from the charged activity and must conclude respondent's assessment is erroneous.

In support of its determination, respondent has made mention of the large amounts of cash deposited into appellant's checking account in 1982 and 1983. **It** is respondent's apparent contention that because the source of these deposits has not been explained, these funds must have constituted receipts from the illegal sale of narcotics and prove that appellant was engaged in such activity in 1984. While we can follow respondent's reasoning process, **we** find that there is an inadequate foundation for respondent's supposition. First, because respondent did not determine under the bank deposits method that these deposits were, in fact, income to appellant, she has no obligation to explain these deposits or show a likely source for the money. (See, e.g., Estate of Mason v. Commissioner, 64 T.C. 651 (1975), affd., 566 **F.2d** 2 (6th Cir. 1977); Stone v. Commissioner, ¶ 83,189 **T.C.M. (P-H) (1983)**.) Second, there is no evidence supporting respondent's suspicion that these deposits arose from the charged illegal activity. Respondent has not ruled out the possibility that these funds came from a legal source. Third, the present jeopardy assessment assumes appellant was engaged in drug activity in the first five months of 1984 while these deposits were made before this assessment period. In **short**, we find that

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the bank deposits do not support respondent's assumption that appellant had unreported income during the relevant period under review.

Finally, respondent argues that appellant owned valuable property in excess of what a person of her modest salary should have been able to buy. **Since** appellant did not show how she could afford to make home mortgage and car loan payments and at the same time support a dependent daughter on her teacher's aide salary, respondent infers from this that appellant was engaged in the illegal sale of drugs and used the unreported income therefrom to finance her life style. We cannot agree with respondent's use of a "net worth" theory to supplement its case. Data provided by the private real estate search company indicates that the assessed value of appellant's home was but \$50,478. On her Schedule A for 1982 and 1983, appellant claimed deductions of **\$1,796** and **\$1,785**, respectively, for home mortgage interest expense and claimed **\$750** and **\$481**, respectively, for real estate tax expense. In 1983, she claimed an interest expense deduction of **\$321** for **payments** on an automobile loan and sales tax deduction of **\$764** for purchase of an automobile. Though required under the net worth method of computing unreported income, respondent did not establish appellant's beginning and ending net worth to account for the use of appellant's **capital to pay for her purchases.** (Taglianetti v. United States, 398 F.2d 558 (1st Cir. 1968).) **Thu** us it **is not inconceivable** that appellant met her expenses on the basis of her annual salary or received contributions from the other members of her household. **We** also note that there is no evidence that income from an illegal activity was ever used to pay for these assets.

Because of our conclusion that there is insufficient evidence in the record to support respondent's determination that appellant received unreported income from the illegal sale of narcotics during the appeal period, it is not necessary for us to comment on the specific method used by respondent to reconstruct **the** alleged income. Based **on** the foregoing, we must reverse respondent's action in this matter.

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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 Gayle A. Jackson for reassessment of a jeopardy assessment of personal income tax in the amount of \$11,010 for the period January 1, 1984, to May 31, 1984, be and the same is hereby reversed.

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

**Abstained