

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
RICHARD E. KOCH) No. 83J-954-KP
)

For Appellant: Robert Baron
Attorney at Law

For Respondent: Grace Lawson
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 Richard E. Koch for reassessment of jeopardy assessments of personal income tax and penalties in the total amounts of \$3,372.00 and \$31,405.40 for the years 1979 and 1980, respectively.

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

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The issue presented by this appeal is whether respondent properly reconstructed appellant's unreported income from the illegal sale of narcotics during the years at issue.

In July 1981, the Manhattan Beach Police Department received information from an informant that he had made several purchases of cocaine from appellant during the prior six months. The informant agreed to make a police-observed buy from appellant. After the controlled sale occurred on August 19, 1981, appellant was arrested and his apartment was searched pursuant to a warrant. The search lead to the discovery of assorted drug paraphernalia, detailed "pay-owe" sheets dating back to January 1981, 7.4 ounces of cocaine, **and** \$2,666 cash.

Upon receiving the above information, respondent, by use of the projection method of income reconstruction, determined that appellant had received unreported income from the illegal sale of narcotics and that the assessment of tax on that income would be jeopardized by delay. Respondent estimated appellant's cocaine sales at one pound per month and determined that he had been selling cocaine since 1979. Respondent further determined that appellant sold the cocaine for \$2,400 per ounce, which was the price appellant charged the informant during the controlled buy. In using these figures, respondent estimated that appellant had unreported income of \$230,400 in both 1979 and 1980, and \$144,000 in 1981. Appellant was also assessed penalties for the failure to file tax returns and negligence for 1979 and 1980. The appropriate assessments **were** issued.

While respondent was considering his petition for reassessment, appellant admitted deriving \$62,400 in drug sales from July to December 1980, and \$16,800 in sales from January 1, 1981, to the date of his arrest. Appellant also admitted to receiving unreported **income** from his mini-blind business in 1979. Despite appellant's statements, respondent upheld all of its previously issued assessments except 1979's. Respondent revised its 1979 assessment to exclude **any alleged** income from the sale of narcotics and to include previously unreported income generated in appellant's mini-blind business and from rent receipts he received that year. An appeal was then filed with this board.

Appellant's appeal does not include respondent's 1981 assessment. Furthermore, appellant has not provided any specific reason or evidence to support

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his general argument that the penalties should not have been imposed. The burden of proving that a negligence or a 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, our only concern is whether respondent committed any error in its reconstructions of appellant's income for 1979 and 1980.

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.)

Respondent does not, however, have unrestricted discretion to reconstruct a taxpayer's income. As stated in the Appeal of Siroos Ghazali, supra:

[I]n order to ensure that the use of the projection method does not lead to injustice by forcing the taxpayer to pay tax on income that he did not receive, each assumption involved in the reconstruction must be based on fact rather than on conjecture. [Citations.] In other words, there must be credible evidence in the record which, if accepted as true, would induce

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a reasonable belief that the amount of tax assessed against the taxpayer is due and owing. [Citations.] If the reconstruction is found to be based on assumptions lacking corroboration in the record, the assessment is deemed arbitrary and unreasonable. [Citations.] In such instance, the reviewing authority may redetermine the taxpayer's income on the facts adduced from the record. [Citations.]

On appeal, appellant claims that there is no factual basis for the 1979 revised assessment. The revised assessment, however, is based upon appellant's own admissions provided in the financial statement he submitted to respondent. A taxpayer who admits to receiving unreported income provides respondent with sufficient evidence to issue a valid assessment. (Appeal of Dennis and Cynthia Arnold, Cal. St. Bd. of Equal., May 6, 1986.) Consequently, respondent's assessment for 1979 will be upheld.

In regards to respondent's reconstruction of income for 1980, appellant's only objection is that it is "arbitrary, capricious, without any basis in fact." (App. Br. at 1.) As appellant presents no other evidence or argument to contradict respondent's determination, the Franchise Tax Board's assessment will be upheld if it is based on assumptions supported by the record. Respondent's determination rests upon four, assumptions: (1) that appellant was in the "business" of selling narcotics and received unreported income from those sales; (2) that appellant sold cocaine for \$2,400 an ounce; (3) that appellant sold one pound of cocaine a month; and (4) that appellant sold cocaine for the entire year of 1980.

The first factor, that appellant was a drug dealer and that he was receiving unreported income from the illegal sale of narcotics, is confirmed by his admission that he received unreported income from narcotics sales in 1980 and 1981. The second factor, the **\$2,400-**an-ounce sales price, is supported by appellant's sale of cocaine to the police informant wherein the informant was charged that price.

The third factor, that appellant sold a pound of cocaine a month, was based upon information provided by the **informant**. This figure may have been a low estimation as the search of appellant's apartment revealed 7.4 ounces of cocaine. Based on 'the risks inherent in the illegal drug business, we have found it reasonable to

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assume that a dealer would only have on hand an amount of drugs that could easily and quickly be disposed of.

(Appeal of Gregory Flores, Sr., Cal. St. Bd. of Equal., Aug. 1, 1984; Appeal of Clarence P. Gondor, Cal. St. Bd. of Equal., May 15, 1974.) An estimated turnover rate of a dealer's drug inventory of once a week is a reasonable basis on which to reconstruct income from drug sales.

(Appeal of Gregory Flores, Sr., supra; Appeal of Clarence P. Gondor, supra.) Based upon the amount of cocaine found in appellant's apartment, respondent would have been justified in determining that appellant had monthly sales of almost two pounds of cocaine, nearly double its present estimate. Accordingly, respondent's determination that appellant sold **at least** one pound of cocaine a month is supported by the record.

The **final** factor used in respondent's estimation is that appellant sold narcotics for all of 1980. Respondent contends that the informant who led the police to appellant had been buying drugs from appellant for three to four years. Respondent also draws support for its determination from a letter written by an unknown party dated August 27, 1981, eight days after appellant's arrest, wherein the unknown party claims to have been told by the informant that **the** informant had been buying cocaine from appellant for at least three years.

We find respondent's reading of the informant's statement regarding his drug purchases rather liberal. The informant stated on July 21, 1981, that he had "known Koch for approximately three (3) years and during the past six (6) months [had] made a minimum of twenty (20) buys of cocaine from Koch at Koch's residence in Manhattan Beach." (Resp. Br., Ex. A.) Even a cursory reading of the informant's statement clearly indicates that the informant admits to have been purchasing cocaine from appellant for six months, which would only account for 1981's sales. Furthermore, respondent's dependence upon the letter received subsequent to appellant's arrest is misguided. While an unknown informant's information may be found to be reliable **because of the subsequent seizure** of contraband (see, e.g., Appeal of Clarence Lewis Randle, Jr., Cal. St. Bd. of Equal., Dec. 7, 1982), none of the information contained in the August 27, 1981, letter was demonstrated to be reliable by any subsequent search or seizure. (See Appeal of Siroos Ghazali, Cal. St. Bd. of Equal., supra.) **Even assuming the letter was written** by a police officer, it was not prepared by one of the arresting officers. Consequently, "[t]he letter itself has none of the indicia of trustworthiness of a

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police crime report, having been written by a non-arresting officer . . ." over one week after appellant's arrest. (Appeal of Siroos Ghazali, supra.)

Accordingly, we do not find respondent's evidence 'convincing as to the time frame of appellant's involvement in the sale of narcotics. Appellant admitted, however, that he sold cocaine from July of 1980 through December of that year. By this admission, appellant confirms half of the time period involved in respondent's 1980 assessment. Consequently, we find that respondent's reconstruction of appellant's income for 1980 is supported by the evidence for the period July 1, 1980, to December 31, 1980, but not for the period January 1, 1980, to June 30, 1980. Therefore, respondent's assessment must be modified to include only the admitted time period of drug sales.

In summary, we find that respondent's projection of appellant's income for the year 1979 and the period July 1, 1980, through December 31, 1980, and its imposition of penalties for those periods to be reasonable when scrutinized against the record in this appeal and that appellant has failed to carry his burden of proving otherwise. In contrast, we find that respondent's projection of appellant's income for the period January 1, 1980, through June 30, 1980, to be unsupported by the record on appeal and that that portion of the assessment must be reversed. Respondent's action in this matter will be modified accordingly.

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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 Richard E. Koch for reassessment of jeopardy assessments of personal income tax and penalties in the total amounts of **\$3,372.00** and **\$31,405.40** for the years 1979 and 1980, respectively, be and the same is hereby modified to exclude any income attributed to the period January 1, 1980, to June 30, 1980. 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.

<u>Richard Nevins</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9