

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
ROSA GALLARDO ) j No. **84J-383-KP**  
)

For Appellant: David R. Reed  
Attorney at Law

For Respondent: Philip M. Farley  
Counsel

O P I N I O N

This appeal is made pursuant to section **18646<sup>1/</sup>** of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Rosa Gallardo for reassessment of jeopardy assessments of personal income tax in the amounts of **\$35,172.62** and **\$1,926.00** for the year **1982** and for the period January 1, 1983, to January 6, 1983, respectively.

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

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The issue presented by this appeal is whether respondent's reconstructions of appellant's unreported income for the year and period at issue are supported by the evidence presented on appeal.

During the latter part of 1982, an investigation by the Federal Bureau of Investigation, the San Francisco Police Department, and the South San Francisco Police Department revealed appellant's involvement in a large cocaine-selling operation. On January 6, 1983, the San Francisco and South San Francisco police, in conjunction with the U.S. Immigration Service, executed a search warrant for appellant's residence. Seized at the location were 12 ounces of cocaine, \$7,880 cash, various papers which appeared to be "pay" and "owe" records of narcotics transactions, a revolver, and a gram scale. Appellant and the several other individuals at the house were arrested. Appellant admitted that all of the drugs **and money found** during the **raid** were hers. She **eventually** pled guilty to several counts of conspiracy to sell cocaine.

Upon receiving the above **information**, respondent determined that appellant had received unreported income from the illegal sale of narcotics and that any delay in issuing assessments for 1982 and 1983 would jeopardize the collection of the tax that was due. **Respondent originally reconstructed appellant's income for 1982 by** cash expenditures she was known to have made during that year. Respondent's 1983 estimate of income was based on the cash found during the raid, \$7,880, and the cost of the 12 ounces of cocaine to appellant, \$2,000 an ounce for a total of \$24,000. The appropriate jeopardy assessments were issued and appellant filed a petition for reassessment.

As a result of the petition, respondent **modified** its 1982 assessment to reflect the drug sales **recorded** in the various records found during the raid. The redetermination increased the assessment considerably. Respondent excluded any reference to its cash expenditure method of reconstruction previously used. The assessment for 1983 was affirmed. 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

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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 **construction of income is erroneous.** (Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

Due to the illegal nature of the sale of narcotics, it is not unusual to find that a drug dealer does not keep any records of his narcotic's sales. When records of drug sales are discovered, they are often written in such a manner that only persons familiar with the activities of narcotics dealers can decipher the information of those records. Accordingly, if there is some basis to believe that records discovered during an investigation of a taxpayer's illegal activities relate to those activities, respondent is justified in interpreting and relying upon the information contained in those records to reconstruct the taxpayer's unreported income. (See Appeal of Mart Conrad Wende, Cal. St. Bd. of Equal., Mar. 1, 1983; Appeal of James Eugene Ely, Cal. St. Bd. of Equal., Sept. 30, 1980.) If such a connection between the records and the activity is established, it is the burden of the taxpayer to show that the records are somehow inapplicable or inaccurate. (See Appeal of Mart Conrad Wende, supra.) An unsupported allegation that the records do not reflect unreported income from illegal activities is insufficient to carry the taxpayer's burden. (Appeal of Mart Conrad Wende, supra.)

Appellant argues that at the petition for reassessment hearing, all of the parties to this action agreed that the majority of the records seized did not constitute records of drug sales. Further, appellant expresses bewilderment as to how respondent arrived at such a high sales figure for 1982 from the remaining

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records as most of those records were not in appellant's handwriting. We do not find merit in these arguments.

In the present case, the records found in appellant's apartment contain several indications that they were records of appellant's 1982 drug sales. First, some of the computations **on the** papers were coupled with the notation "**g.**," a common abbreviation for grams, and cocaine is commonly sold in a powdered form in units measured in grams. Secondly, some **of the** records were coupled with the terms "**paid**" and "**owed**," terms commonly used in the drug trade. Finally, appellant **has** failed to provide a credible explanation of what the records were recording, if they were not notations of drug sales. We also note that respondent has provided this board with copies of the documents used to reconstruct appellant's drug sales, and **that the figures on those documents** appear to be accurately translated to respondent's work sheets. **Furthermore,** respondent's addition of those figures to arrive at **appellant's** unreported income for 1982 is correct. The fact that appellant is "bewildered" by respondent's estimate of income does not satisfy her burden of proving that respondent's reliance on those records was incorrect. (Appeal of Mart Conrad Wende, supra.) Further, it is appellant's burden to prove that sales of narcotics reasonably attributed to **her did not occur** or were not conducted by **her**, and unsupported statements that she did not write the records of drug sales do not satisfy that burden. (See Miller v. Commissioner; ¶ 81,249 T.C.M. (P-H) (1981); Appeal of Roland Aranda Garcia, Cal. St. Bd. of Equal., Mar. 4, 1986.) Consequently, we find that respondent's determination that the writings in question were records of appellant's drug sales during 1982 is supported by the record, and that respondent was justified in relying upon those records when reconstructing appellant's unreported income for that year. (Appeal of Mart Conrad Wende, supra.)

In its assessment for 1983, respondent used the cash expenditure method of reconstructing income and the net worth method to estimate appellant's income from the sale of cocaine. 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

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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 and 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.)

a There is no indication in the record that appellant acquired the drugs with income generated in 1983 or that the money found in her house represented drug sales from that year because there is no evidence as to appellant's opening net worth for 1983. (See Taglianetti v. United States, supra.) The only indication of appellant's financial worth is the unreported income we

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have found attributable to 'appellant in 1982. This knowledge of one year's income does not, however, give us any insight into appellant's overall financial picture prior to or during the year at issue. (Cf. Taglianetti v. United States, supra.) If she had failed to file tax returns for several years prior to the appeal years, it might be reasonable to assume that appellant's net worth at the beginning of 1983 was zero (see Cohen v. Commissioner, 176 **F.2d** 394 (10th Cir. 1949); see also Appeal of Dennis and Cynthia Arnold, Cal. St. Bd. of Equal., May 6, 1986, footnote 2), but we have not been supplied with that information. While we agree with respondent that the cash expenditure method of reconstruction does not require the same exactness as 'the net worth method requires in determining the opening balance of a taxpayer (Taglianetti v. United States, supra, 398 **F.2d** at 564-565), this case ~~does~~ **does not present the necessary facts to** 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, 398 **F.2d** at 565.) Without a starting balance, we find it is just as likely that the drugs were acquired in late 1982 with unreported income from that year as it is that they were acquired in the first few days of 1983 with unreported income generated in that year. Furthermore, **there are no known sales of cocaine** conducted by appellant in 1983. Therefore, without known sales or a starting balance, there is nothing to indicate when or how appellant acquired the **\$7,880 in cash**. Consequently, we find that respondent's assessment for 1983 is not supported by the record and must be reversed in its entirety.

In summary, we find that respondent's projection of appellant's income from the illegal sale of cocaine, for 1982 to be reasonable when scrutinized against the record on appeal. On the other hand, we find that respondent's determination that the cocaine discovered at appellant's house was acquired with income generated in 1983 and that the cash discovered in the same raid represented unreported income from sales of cocaine in 1983 is not supported by the record on appeal. Respondent's action in this matter must be modified accordingly.

