

BEFORE T&E STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
SALUD C. ARELLANO ) No. 85R-49-KP

Appearances:

For Appellant: Fred Jay Lauber  
Attorney at Law

For Respondent: Lorrie K. Inagaki  
Counsel

O P I N I O N

This appeal was originally made pursuant to section ~~18546~~ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Salud C. Arellano for reassessment of jeopardy assessments of personal income tax and penalties in the total amounts of \$30,929.66 and \$36,588.96 for the year 1981, and for reassessment of jeopardy assessments of personal income tax in the amounts of \$45,682.25 and \$46,645.25 for the period January 1, 1982, to May 18, 1982, and the year 1982, respectively. Subsequent to the filing of this appeal, appellant paid the jeopardy assessments in full. Accordingly, pursuant to section 19051.1 of the Revenue and Taxation Code, this appeal is treated as an appeal from the denial of claims for refund.

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

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The issue on appeal is whether respondent properly reconstructed appellant's income for the year and period at issue.

On April 15, 1982, the Los Angeles Police Department received information from a confidential informant that appellant was heavily involved in the sale of large amounts of cocaine. Subsequently, police surveillance of appellant's activities and acquaintances was instituted. During the surveillance period, appellant was observed leaving her residence to make several phone calls from a pay phone. Upon completing her calls, appellant proceeded to drive around a two-square-mile area for two hours in an apparent attempt to detect any police surveillance of her movements. At the end of the two-hour period, appellant drove to a motel where she met several other individuals in a private room. Due to the informant's statements and the fact that appellant's above-described activities were consistent with those of a drug dealer, the police proceeded to conduct a raid of the motel room. Due to the discoveries described below, appellant and the three other individuals discovered in the motel room were arrested and charged with conspiracy to sell cocaine.

During the raid, the police found several suitcases filled with cocaine and money. The police also discovered four hand guns, a scale, and several notebooks and a ledger detailing over \$2.5 million and \$4.5 million in narcotics sales for 1981 and 1982, respectively. In questioning the suspect who rented the motel room, the police discovered that the individuals had used the room on other occasions for other drug sales. A fifth person who had left the motel room prior to the raid was arrested at a different location and charged with the other four individuals. At the second-location, the police found more cash and cocaine in an apartment which they believed to be a storage room for large amounts of cocaine. In total, the police confiscated \$411,696 in cash and 87.87 pounds of cocaine between the two locations. A subsequent police check of the ledger revealed that appellant's fingerprints were on the pages of the book, and a subsequent analysis of some of the entries by a handwriting expert revealed that appellant had made several of the entries in the journal, including the statements: "I paid a total of [\$]1,480,000 within a two week period April 1 to April 15, 1982" and "I received three and a half kilograms." (Resp. Br., Ex. F at 2.) Appellant was eventually convicted of conspiracy to sell narcotics and was sentenced to 20 years in prison.

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An investigation of appellant's finances revealed that she had no-visible means of support but that she was the owner of six vehicles and two homes. The police also searched appellant's safe deposit box which contained \$53,000 in cash and jewelry worth over \$320,000. It was further discovered that appellant was a partner in an art gallery and that she had contributed over \$40,000 to its operation. She never took a salary from the art gallery and the partnership always operated at a loss during the years at issue.

When respondent was informed of the above events and discoveries, it determined that appellant had unreported income from the illegal sale of narcotics and that the collection of the tax on that income would be jeopardized by-delay. Respondent's initial reconstruction of appellant's income was calculated based on the narcotics records found at the time and place of appellant's arrest less a 50 percent deduction for the cost of goods sold. Its assessments were also based on a finding that appellant and the other four individuals arrested were equal partners in the cocaine ring and that appellant should only be held responsible for her share of the profits. On February a, 1983, respondent issued additional assessments for the two taxable periods in question based on the elimination of the cost-of-goods deduction pursuant to the enactment of section 17297.5.<sup>2/</sup> Appellant filed petitions for reassessment for both sets of assessments. Appellant refused, however, to candidly discuss her finances, including the narcotics sales. As a result, respondent denied the petitions and this appeal followed.

Under the California Personal Income Tax Law, an individual is required to report 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

<sup>2/</sup> Former section 17297.5, in pertinent part, stated that "(a) [i]n 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 ...." Section 17297.5 was specifically made retroactive to all taxable years which were not closed by the statute of limitations or otherwise. (Rev. & Tax. Code, § 17297.5, subd, (c).) Section 17297.5 was reenacted in 1984 as section 17282. (Stats. 1984, Ch. 962.)

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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-B) ¶ 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, § 12561; 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 to prove that a reasonable reconstruction of income is erroneous. (Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

Appellant's only objection to the present assessments is that they are arbitrary, capricious, and without any basis in fact. 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, (Appeal of Richard F. Koch, Cal. St. Bd. of Equal., June 10, 1986.) Respondent based its determinations on the following assumptions: (1) that appellant engaged in the sale of narcotics and received unreported income from those sales for the periods at issue: (2) that the ledger and notebooks found during the search of the motel were records of drug sales of a partnership of which appellant was a partner; and, (3) that appellant and the four others arrested with her were engaged in a "partnership" to sell cocaine and that they each received an equal share of the profits of the partnership as recorded in the drug records.

The first question presented is whether appellant was in the business of selling cocaine. A police surveillance of appellant's activity revealed that she followed a pattern of behavior used by a person involved in drug sales, including the use of several vehicles to deter surveillance and the seemingly endless circling of city blocks in an attempt to discover whether the police were following her. When arrested, appellant was found in a room with large amounts of cocaine and cash, and a ledger which recorded apparent drug sales in her

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handwriting. Finally, appellant was found guilty of conspiracy to sell cocaine. Consequently, we find that these facts, coupled with appellant's failure to produce evidence to the contrary, support a prima facie showing that appellant was in the business of selling cocaine and that she received income from that business,

The next issue presented is whether the ledger and notebooks found during the search of the motel room were records of narcotics sales, and, if so, whether those were records of a narcotics partnership of which appellant was a partner. 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, (Appeal of Rosa Gallardo, Cal. St. Ed. of Equal., July 29, 1986.) Accordingly, if there is some basis to believe that records discovered during an investigation of a taxpayer's illegal activities related 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. Ed. of Equal., Sept. 30, 1980.) Respondent's determination that the records seized during appellant's arrest were drug records is based on the testimony of a police expert during appellant's trial. (Resp. Br., Ex. I.) While this testimony is hearsay, this board may consider any relevant evidence provided that it is the sort of evidence on which reasonable persons are accustomed to rely in the conduct of serious affairs.. (Appeal of Siroos Ghazali, supra.) We believe that expert testimony given during a criminal trial is the sort of evidence upon which reasonable persons rely in the course of serious affairs. Consequently, we find that respondent's determination that the records were drug records is supported by credible evidence.

If a connection between the records, the drug selling activity, and the taxpayer is established, it is the burden of the taxpayer to show that the records are somehow inapplicable or-inaccurate. (See Appeal of Rosa Gallardo, supra.) An unsupported allegation that the records are not the taxpayer's or do not reflect unreported income from illegal activities is insufficient to carry the taxpayer's burden. (Appeal of Rosa Gallardo, supra.) Appellant's fingerprints were found on the drug records. Expert testimony at appellant's trial indicated that appellant wrote some of the ledger's entries. We

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also note that at least one of the entries in appellant's handwriting is reasonably interpreted as an admission that she sold narcotics. Therefore, we find that sufficient evidence in **the record exists** to tie appellant to **at least** some of narcotics sales listed in the ledger.

As appellant has failed to present any evidence to contradict the finding that she was in some way responsible for some of the narcotics sales listed in the ledger, the only question remaining is **whether** appellant was in a "partnership" that made the sales of cocaine registered in the ledger and notebooks and whether she may have attributed to her 1/5 of the total sales of the alleged "**partnership**" as was determined by respondent, Section 17008 defines the term "partnership" to include a "syndicate, group, pool, joint venture, or other **unincorporated organization through, or by means of which any** business, financial operation, or venture is carried on." A partnership need not be formally recognized and may be implied **from the** conduct of the **parties.** (Galluzzo v. Commissioner, ¶ 81,733 T.C.M. (P-E) (1981).)

A partnership is created when persons **join** together their money, goods, labor, or skill for the purpose of carrying on a **trade, profession, or business** and when there is community of interest in the profits and losses. In determining the existence of a partnership ... the question is whether, **considering all** of the facts, the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. (Citations.) The issue is a factual one. (Citation.) Among the factors to be considered are whether an alleged partner's contributed services are vital and essential to the partnership's successful operation and whether he or she shares in the management and control of the business., (Citations.)

(Galluzzo v. Commissioner., supra at 81-2879.)

[The Internal Revenue Service's] **partner-**ship theory, properly conceived, is not an oppressive technicality designed to charge hapless **taxpayers** with phantom income, but is merely a restatement and **specific** application

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of the venerable principle that income **must** be taxed to him (or her) who earns it.

(Citations.) Thus, one who contributes absolutely nothing to a joint venture's business enterprise cannot be taxed on any of its income. (Citation.)

(Galluzzo v. Commissioner, supra at 81-2879.)

Section 17856 stated, in pertinent part, that "[a] partner's distributive share of income, **gain**, loss, deduction, or credit ... shall be determined in accordance with the partner's interest in the partnership ... if-(a) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit . ..."

In the present case we find that **the** record on appeal supports respondent's determination that a **part-**nership existed. The notebooks and ledgers that recorded the drug transactions in question were, according to handwriting experts, written by several **persons**, one of whom **was identified as appellant**. **All of the persons** arrested with appellant appeared in some **manner** to be involved in the buying and selling of large amounts of cocaine. Each person **was observed** conducting **anti-**surveillance activities prior to their attempted cocaine transaction. Finally, the one person arrested at the second location had left the others to go to an apartment that was used solely to store large quantities of cocaine in an apparent attempt to obtain more **cocaine**.

These actions, plus the presence of the drug ledger, indicate that the arrested individuals **were** all participating in the sale of **cocaine**. What is not indicated by this evidence is that all five individuals were part of the same narcotics ring or partnership. Logically, if a sale was interrupted by the police raid, at least one of the persons present would have **'been** buying the narcotics from or selling the narcotics to the group that owned the ledger--**appellant's partnership**. Consequently, as at least one of those arrested **was** a separate buyer or **seller**, respondent was **generous** in including all of the arrested individuals in appellant's partnership. Furthermore, we note that if there were more than five partners in the drug ring or if some of those arrested were not partners, appellant had ample opportunity to provide us with that **information**, an opportunity of which she failed to take advantage. Therefore, we find that respondent was **reasonable** in

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concluding that appellant was a member of a five-person partnership. Due to the absence of a partnership agreement, appellant may be credited with 1/5 of the partnership profits. (See Rev. & Tax. Code, § 17856.)

In summary, we find that the record on appeal supports the elements of respondent's reconstruction of appellant's income for the periods at issue. Given that appellant has the burden of proving that a reasonable reconstruction of her income was erroneous and that she has failed to present evidence to support her claim, we must conclude that respondent properly assessed appellant's income for the year and period in question. (Appeal of Marjorie Lillie Davis, Cal. St. Bd. of Equal., Apr. 9, 1986.) Accordingly, respondent's action in the matter must be sustained.

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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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of **Salud C. Arellano** for refund of **personal** income tax and penalties in the total amounts of **\$30,929.66** and **\$36,588.96** for 1981, and for refund of personal income tax in the amounts of **\$45,682.25** and **\$46,645.25** for the period January 1, 1982, to May 18, 1982, and 1982, respectively, be and the same is hereby **sustained**.

Done at Sacramento, California, this 3rd day Of December , 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