



BEFORE **THE** STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
BRUCE A. FOOTE ) No. 85J-677-MA

Appearances:

For Appellant: Donald E. Stevens  
Attorney at Law

**For** Respondent: Grace Lawson  
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 Bruce A. Foote for reassessment of a jeopardy ~~assess-~~ment of personal income tax and penalties in the amount of \$56<sup>2/</sup> for the year 1982 and in the amount of \$15,452 for the period January 1, 1983, to June 23, 1983.

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.

2/ The Franchise Tax Board has abated the entire ~~assess-~~ment for 1982.

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The two issues raised in this appeal are whether appellant received unreported income from illegal drug activities or from other **activities** during the appeal period, and if so, whether respondent properly reconstructed the amount of that income.

Sometime in mid-June 1983 the Los Angeles County Sheriff's Department learned through a confidential informant (hereinafter "**CI**") that appellant had been selling cocaine. Using the CI, the Sheriff's Department arranged a controlled buy of **cocaine**. On June 22, 1983, the Sheriff's Department obtained a warrant to search appellant's apartment and in the resulting search discovered an **O'Haus Triple Beam Scale**, five vials containing cocaine residue, a large plastic baggie containing twenty-four grams of marijuana, **numerous weapons, and ledgers indicating cash transactions**. Appellant and a roommate were arrested; but charges of possession of marijuana and cocaine for sale were never **filed**.

Based on appellant's sale of cocaine to the CI, the seizure of the narcotics paraphernalia and ledgers, and appellant's failure to file a timely 1982 tax return, respondent issued jeopardy assessments for taxable years 1982 and 1983 (January 1, 1983 through June 23, 1983) in the amounts of **\$20,634.36** and **\$21,090.58**, respectively.

Appellant filed a petition for reassessment, and a hearing **was held** November 27, 1984. Based on the ledgers and post-hearing evidence submitted, the hearing officer recommended an adjustment **downward** of the jeopardy assessments for both taxable years. The **recommended** reduced jeopardy assessments **were** based on information contained in appellant's ledgers and the hearing officer's discussions **with** appellant and his representative. Subsequently, respondent issued an account abatement notice reducing the jeopardy assessments. **Later**, respondent determined the remaining jeopardy assessment for taxable year 1982 should be abated in its entirety.

On appeal, appellant argues that the information relied upon by respondent in making its jeopardy **assessment** falls far short of the information usually relied on in similar cases and concludes that there is insufficient information to conclude that appellant was engaged in illegal sales of a **controlled** substance. **Moreover**, **appellant argues** that the various adjustments which respondent has made indicates that

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respondent's calculations are unreliable. Lastly, contending that the records seized do not refer to sales of a controlled substance, but, rather a T-shirt business, appellant argues that he should be allowed a cost-of-goods-sold deduction.

Respondent answers that **appellant** has provided no substantiation regarding the nature of the goods allegedly purchased and sold or of the income thereby derived. Moreover, respondent contends that the evidence submitted by appellant does not substantiate a cost-of-goods-sold deduction.

Both the federal and state income tax regulations require each taxpayer to maintain such accounting records as will enable him to file a correct return. (Treas. Reg. § 1.446-1(a)(4) (1985).) If the taxpayer does not maintain such **records**, the taxing agency is authorized to compute his income by whatever method will, in its judgment, clearly reflect income. The existence of unreported income may be demonstrated by any practical method of proof that is 'available' (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) 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.) The presumption is rebutted, however, where the reconstruction is shown to be arbitrary and excessive or based on assumptions which are not supported by the evidence. (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).)

The data relied upon by respondent in the instant case in reconstructing appellant's income was derived from information contained in the affidavit for the search warrant of appellant's house, the arrest reports and evidence reports, ledger sheets seized at the time of appellant's arrest, and a bank account reconciliation. On this basis respondent determined that during the period January 1, 1983, to June 23, 1983, appellant had a taxable income from illegal drug sales of \$154,612 with a resulting tax liability of \$15,452. (Resp. Br., Ex. E.) This is the amount agreed upon by

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appellant at the hearing held November 27, 1984. (Resp. Br., Ex E and Hrg. Tr., p. 16.) Appellant still agrees that this is the amount of unreported income for the period in question but argues that he should be given a cost-of-goods-sold deduction for his T-shirt inventory as shown in his Exhibit 3. (App.'s Br., Ex. 3.)

According to appellant certain of the pages in his personal financial records reflected purchases of goods for resale (T-shirts and other items of clothing.) Appellant contends that he is, therefore, entitled to a reduction for cost of goods sold. According to appellant the cost of goods sold averaged 84.6 percent of the final selling price. On this basis, appellant submits he is entitled to a reduction of \$136,858 in the amount of **unreported** income (from \$161,782 to \$24,914) and to a corresponding reduction in the amount of **his tax** liability.

Generally, cost of goods sold is computed by adding to the inventory at the **beginning** of the taxable year **the** cost of merchandise and materials **purchased** or produced during the year, plus all other costs related to obtaining or producing the merchandise. This total **represents** the cost of goods **available for sale**. From this total there is subtracted the inventory at the **close** of the taxable year. The remainder is the cost of **goods** sold. When that figure is subtracted from total sales, the result is the amount of gross income from sales. In the instant case, appellant has failed to meet his burden of proof with regard to the cost of any goods sold. **There** has been no offer of proof with regard to the amount of inventory or the cost of merchandise purchased or produced during the year. As such we are left with the agreed upon amount of \$154,642 in unreported income for the period in question and no **corresponding** deduction for cost of goods sold. Because of appellant's concession concerning the amount of **unreported** income, we need not reach the question of whether **appellant** was involved in any illegal sales of a controlled substance; however, we note that there is an absence of other information suggesting any other income-producing activity.

Appellant's other argument that the various adjustments to the original jeopardy assessment on respondent's part indicate that respondent's calculations are unreliable is without foundation. **Respondent's** adjustments reflect every attempt to give appellant the benefit of the doubt with respect to the various ledger

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entries and are a result of the respondent's hearing officer's meeting with appellant, Rather than showing respondent's unreliability, the adjustments reflect an interest on respondent's part to reach a figure fully supported by the evidence.

For the foregoing reasons, respondent's action in this matter is sustained in all respects.

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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 Bruce A. Foote for reassessment of a jeopardy assessment of personal income tax in the amount of \$15,452 for the period January 1, 1983, to June 23, 1983, 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.

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

