



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
JAMES GODFREY GALLARDO )

For Appellant: Harvey A. Schneider  
Attorney at Law

For Respondent: Bruce W. Walker  
Chief Counsel

Kendall Kinyon  
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in partially denying, to the extent of **\$5,853.99**, the petition of James Godfrey Gallardo for reassessment of a jeopardy assessment of personal income tax in the amount of \$27,600 for the year 1974.

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The jeopardy assessment in question is based on respondent's reconstruction of income which appellant James Godfrey Gallardo allegedly earned selling heroin. It was issued one day after appellant was arrested on drug-related charges. The following summary of the events leading to this arrest is taken from reports of the Los Angeles Police Department.

In December 1974 an unidentified informant told police officers that appellant was dealing in illegal narcotics. Another unidentified informant made similar allegations late in January 1975. On or about February 3, 1975, the officers began a surveillance of appellant's residence, and over the next ten days they watched several suspected narcotics users and pushers visit the residence.

On February 14, 1975, the officers observed appellant enter a motel room which they thought might be occupied by narcotics users. Some time later appellant and several other individuals left the motel room, got into appellant's truck, and began to drive away. Since the officers suspected that appellant had sold narcotics to these individuals, they stopped the vehicle and searched all the suspects. On one of the suspects the officers discovered approximately three and one-half ounces of heroin which, according to respondent, would be worth about \$2,625 (\$750 per ounce). No narcotics were found in appellant's **possession**, however, and he had only \$169 with him at this **time**.

The officers arrested appellant for conspiracy to sell narcotics. While he was being booked, appellant **consented** in writing to a search of his home. This search resulted in the discovery and seizure of about one-half pound of "green leafy plants resembling marijuana," small amounts of other drugs (but not heroin), and \$3,700 in cash. **It** does not appear from the police reports whether the "green leafy plants" were ever actually identified as marijuana. Appellant was subsequently released from custody, and no charges were ever filed against him as a result of this arrest.

The jeopardy assessment in question, which was originally issued in the amount of \$27,600 for the year 1974, was based on two assumptions. First, respondent presumed that **appellant had** been selling drugs continuously for more than 13 months prior to his arrest, that is, since January 1, 1974. The record does not reveal the information, if any, upon which this assumption was based.

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Respondent next estimated that appellant had received an average of \$5,000 per **week from** such sales or a total of \$260,000 for the appeal year. Again, it is not clear from the record just how respondent arrived at this figure.

Subsequently appellant filed a California personal income tax return for the year 1974 reporting wages he had earned as a part-time welder. He also reported over \$38,000 in gross receipts from a jewelry business. It appears that appellant periodically visited Indian reservations to purchase handcrafted items, usually paying cash, then resold those items for cash at craft shows and swap meets. Appellant did not report any income from heroin sales.

After a hearing with appellant and his representative, respondent decreased the jeopardy assessment from \$27,600 to **\$5,853.99**. The revised assessment is based on the following. In January or early February 1975, an individual named Alonzo was arrested on charges of selling heroin. Alonzo had in his possession a notebook and various scraps of paper. Notations had been written on these papers between December 20, 1974, and January 20, 1975, apparently in a foreign language. Copies of these papers have not been made available to us, but respondent has submitted translations which seem to have been prepared by police officers. According to the translations, the papers record statements of which the following are typical:

TO BETOS JOHN I DELIVERED 5 PIECES  
ONE 600 AND THE OTHER 500

TO MR ORTIZ I DELIVERED THE QUANTITY OF  
11 PIECES. HE OWES ME 3 AT 550.

**JIMMIE** I GAVE 12 PIECES - 500

JOHN I GAVE **15** PIECES - 500

TO MR. **MAURICE** 8 PIECES - 600

On one scrap of paper the name "Jimmie" was followed by a number which turned out to be appellant's telephone number.

Respondent assumed that these scraps of paper were records of narcotics transactions, and that each "piece" represented or was equivalent to one ounce of heroin. It assumed further that appellant was not only the "Jimmie" whose telephone number was written on one scrap of paper, but that he was also the "Jimmie" mentioned on the other scraps. By totaling **the number** of

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"pieces " associated with the name "Jimmie," respondent concluded that appellant had purchased 84 ounces of heroin from Alonzo between December 20, 1974, and January 20, 1975. It assumed further that he had resold all 84 ounces in December, 1974 for an average of \$750 per ounce, **receiving** a total of \$63,000 from the sales. Finally, respondent determined that the entire \$63,000 was taxable income to appellant.

The principal issue on appeal is whether this reconstruction of appellant's income for 1974 was reasonable.

When a taxpayer does not maintain adequate accounting records, respondent may reconstruct his income by whatever method will, in its opinion, clearly reflect income. (Rev. & Tax. Code, § 17561, **subd. (b)**; Cal. Admin. Code, tit. 18, reg. 17561, **subd. (a)(4)**.) A reasonable reconstruction is presumed correct, but the presumption is rebutted if the reconstruction is shown to be arbitrary and excessive or based on assumptions which are not supported by the evidence. (Appeal of David Leon Rose, Cal. St. Bd. of Equal., **March 8, 1976** ) **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. (Appeal of Burr McFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.)

In this case, the reports of the Los Angeles Police Department reveal little more than that appellant associated with suspicious characters. Although police officers believed that appellant had sold heroin to the motel occupants on the day he was arrested, he had only \$169 on his person, and it is therefore difficult to assume that a sale of heroin worth \$2,625 actually took place. The discovery of \$3,700 in appellant's home is not surprising, since he customarily handled large amounts of cash in conducting his jewelry business. In short, except for the allegations of unidentified informants, there is nothing in the police reports linking appellant with any sales of heroin or other drugs. It is simply unreasonable to assume, on the basis of these reports, that appellant earned \$63,000 in taxable income from drug sales. (Appeal of Burr McFarland Lyons, supra.)

Moreover, the translated copies of Alonzo's notations are not credible **evidence**, even assuming that the translations are accurate. The regulations which govern proceedings before this board provide:

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Any relevant **evidence...will** be admitted if it is the sort of evidence on which responsible persons are accustomed to rely in the conduct of serious affairs. . . . [C]omments on the weaknesses of evidence will be considered in assigning weight to the evidence. (Cal. Admin. Code, tit. 18, reg. 5035, subd. (c).) (Emphasis added.)

Alonzo's scraps of paper can be construed as supporting the assessment only if it is assumed that they record narcotics transactions and that each "piece" equals one ounce of heroin. Without some corroboration for these assumptions, and none has been presented, we can assign no weight whatsoever to these scraps of paper. (See Willits v. Richardson, 497 F.2d 240 (5th Cir. 1974).)

The reconstruction of appellant's income suffers from problems more fundamental than a lack of supporting evidence, however. For example, respondent made no allowance for the cost of the heroin which it presumed was sold, and the reconstruction is therefore based in part on receipts which cannot be considered taxable income. (Appeal of Felix L. Rocha, Cal. St. Bd. of Equal., Feb. 3, 1977.) More importantly, the reconstruction includes some income allegedly earned on resales of heroin purchased in January 1975. Obviously, any such resales would not produce taxable income in 1974. The Revenue and Taxation Code does not allow income earned in one year to be taxed in a prior year simply because respondent believes that the taxpayer is dealing in narcotics.

Respondent offers one final argument in support of its assessment. At the oral hearing on his petition for reassessment, appellant stated that he had purchased a truck in 1974 for \$4,000 cash. When respondent compared this statement with information on appellant's 1974 tax return, it appeared that appellant's known expenditures had exceeded his reported taxable income for that year by \$441.82, even disregarding the living expenses of appellant, his wife, and their four children.

Respondent's computations are, in effect, the beginnings of a reconstruction by the net worth method or the excess cash expenditures method. If respondent had followed up on these beginnings, by establishing appellant's opening net worth or opening cash on hand, it might well have arrived at a reasonably accurate reconstruction of appellant's taxable income. The choice

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of a **reconstruction** method is, however, a matter entirely **within** respondent's discretion (see Harold E. Harbin, 40 T.C. 373 (1963)), and in this case respondent chose not to employ either of these more traditional methods.

Because respondent did not follow up on this lead, its computations at present indicate only that appellant had access to funds or credit which exceeded **his** reported taxable income by something more than \$440. As the record now stands, we cannot assume that this **excess** represents taxable income. (See Olinger v. Commissioner, 234 F.2d 823 (5th Cir. 1956).) In any event, respondent's computations fall far short of indicating that appellant earned \$63,000 in unreported **taxable income**.

For the above reasons, we reverse respondent's action.

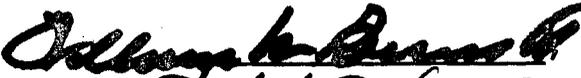
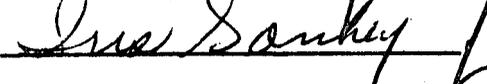
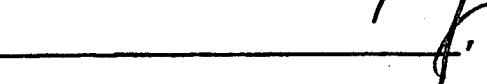
O R D E R

Pursuant to the views expressed in the opinion of the board on 'file in this proceeding,, and good cause appearing therefor,,

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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 partially denying, to the extent of \$5,853.99, the petition of James Godfrey Gallardo for reassessment of a jeopardy assessment of personal income tax in the amount of \$27,600 for the year 1974, be and the same is hereby reversed.

Done at Sacramento, California, this 28th day of September, 1977, by the State Board of Equalization.

 Chairman  
 Member  
 Member  
 Member  
 Member