

Appeal of Gregory Lynell Wyatt

The issue presented is whether respondent has properly reconstructed the amount of unreported income from illegal sales of cocaine which appellant received during the period at issue.

Having received information indicating that appellant was selling cocaine, **deputies** of the Los Angeles Sheriff's Department, Narcotics Division, conducted a surveillance of appellant's **residence** during the week of March 14, 1982. One deputy, **Thomas Gordon**, indicated in his report that on the three surveillances at appellant's residence, he observed an average of five **persons per hour** entering **the residence**, staying for only a brief time. **Deputy Gordon** concluded that such behavior indicated narcotics trafficking. (**Resp. Br., Ex. A.**) Between March 22 and March 24, 1982, Deputy Gordon learned from a **confidential informant (CI)** that **appellant** was selling cocaine from his residence and that the **CI** himself had purchased cocaine from the appellant about 15 times over the previous six months at \$50 per one-half gram or \$100 per **gram**. Under the direction and control of the **sheriff's department**, the **CI** made a recorded telephone call to appellant arranging for the purchase of one-half of a gram of cocaine. Based upon the above information, a search warrant was obtained for the person and residence of appellant. That search produced the following items:

1. Approximately **26 grams** of cocaine.
2. \$13,563 in cash.
3. Five measuring spoons with cocaine residue.
4. An **"OHAUS"** gram scale.
5. An **"UZI"** machine gun.
6. A Browning **9mm** semi-automatic pistol.
7. **.38-caliber** derringer.
8. Seven packages of mannite used as an additive to cocaine.
9. Narcotics pay-and-owe sheets.
10. Various personal property such as four new color television sets, two **complete** stereo sets, an **arcade-** type video set, four new **35mm** cameras, a video

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recorder, approximately 50 gold watches, and 50 gold rings.

11. Various bank records.

Based upon the above, appellant was charged with violation of section 11351 of the Health and Safety Code (Possession of Cocaine for Sale) to which he subsequently pled guilty.

Upon being notified of appellant's arrest, respondent determined that collection of personal income taxes for 1981 and 1982 would be jeopardized by delay.^{2/} Accordingly, based upon information contained in the sheriff's report, respondent determined that appellant's cocaine sales had resulted in unreported taxable income for at least ~~the six-month period during~~ which the CI had been purchasing drugs, i.e., October 1 through December 31, 1981, and January 1, 1982, through March 26, 1982. Respondent further determined that appellant sold cocaine 8 hours a day, 30 days a month, and that he averaged 7 sales per hour. After deducting 50 percent for cost of goods sold, respondent concluded that appellant had daily net income from cocaine sales of \$1,400^{3/} or full monthly sales (based on 30 days) of \$42,000. In addition, for 1981, respondent used a method which it termed the linear progression method attributing one-third of a full month's sales to October, two-thirds of a full month's sales to November, and a full month's sales

2/ Appellant's 1981 personal income tax return reported no income from the sales of narcotics, reporting only taxable income of \$4,926 from "rents and royalties."

3/ Respondent's computations are as follows:

Sales Price per one-half gram	\$ 56.00
Number of Sales per Hour	x 7
Gross Sales per Hour	\$ 350.00
Cost of Goods Sold @ 50%	175.00
Net Income per Hour	\$ 175.00
Number of Sales Hours per Day	x 8
Daily Net Income from Sales	\$ 1,400.00
Average Days per Month	x 30
Average Monthly Income	<u>\$42,000.00</u>

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to December. ^{4/} Moreover, for 1981, respondent: added appellant's bank deposits of \$8,566 as of October 1, 1981, as previously earned income from cocaine sales. These computations resulted in additional taxable income of \$92,524 for the period of October 1, 1981, through December 31, 1981, and income of \$117,600 for the period January 1, 1982, through March 26, 1982. Based on these figures, jeopardy assessments were issued for \$8,892 and \$11,651 for 1981 and 1982, respectively.

Appellant petitioned for reassessment of the above jeopardy assessments. By notice of action dated August 31, 1983, respondent determined that the 1981 assessment should be affirmed^{5/} but that the 3.982 assessment should be reduced from \$11,651 to \$4,896. Respondent grounded the reduction for 1982 upon its conclusion that daily income from cocaine sales was \$700 rather than \$1,400 based upon its understanding that a daily pay-and-owe sheet kept by appellant indicated he sold seven grams at \$100 per gram per day. Those records

4/ Respondent has given no explanation or basis for the linear progression method, but it appears that this method attempts to discount the sales for a new business venture,

5/ The notice of action noted that appellant admitted to his probation officer that he had been selling cocaine for approximately one year rather than six months as initially used by respondent. Relying on this information would change the assessment period for 1981 from October 1 through December 31, to April 1 through December 31, and would increase the amount of cocaine-related income for 1981 from \$92,524 to \$189,000. Nevertheless, at that time, respondent chose not to amend its initial jeopardy assessment for 1981. The August 31, 1983, notice concluded that the initial jeopardy assessment should be affirmed because of the "admitted longer sales period" and because the cost of goods sold deduction should be disallowed. However, by a later notice of assessment dated March 9, 1984, respondent did, in fact, adopt the underlying information of the August 31, 1983, notice of action to increase both the period covered and the amount of taxable income for 1981. This revision resulted in a total revised tax for 1981 of \$20,088. However, since this notice was issued subsequent to the filing of this appeal and has not been appealed, it is not before us at this time.

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indicated that for one day, 11 cocaine sales were recorded, 7 grams of cocaine were sold, and gross income amounting to \$740 was received. (Resp. Br., Ex. X.) That report also concluded that appellant's cocaine sales began April 1, 1981, rather than October 1, 1981, based upon the fact that after his arrest, he had told his probation officer that he sold cocaine for approximately one year. The August 31, 1983, notice also concluded that (1) based upon the sheriff's report (Resp. Br., Ex. A.), it was unreasonable to assume more than five sales per hour took place or that appellant operated eight hours per day, seven days a week; (2) the use of the linear progression method was unreasonable; and (3) pursuant to section 17297.5, the cost of goods sold deduction previously allowed should be disallowed. This appeal followed.

Initially, we note that while two assessments were issued at different times for 1981, the only assessment before us in this appeal is the first one issued March 26, 1982; however, respondent's revised theory in support of this assessment is based on charging appellant with all taxable income allegedly received during 1981 as reflected by the pay-and-owe sheets (i.e., \$189,000 for the period April 1, 1981, through December 31, 1981)^{6/} and not merely the income originally reflected in the first assessment (i.e., \$92,524 for the period October 1, 1981, through December 31, 1981). The modified computation is reflected on the August 31, 1983, notice of action which, while affirming the amount of the original jeopardy assessment for 1981 at \$8,892, did not condone the reconstruction method upon which the notice was based using instead a new basis for computation (Appeal of Philip Marshak, Cal. St. Bd. of Equal., Mar. 31, 1982).^{7/}

6/ Respondent determined that appellant received \$700 a day from cocaine sales beginning on April 1, 1981. Respondent's reconstruction (i.e., 270 days times \$700 per day of income) would result in taxable income of \$189,000 for 1981.

7/ See also 9 Mertens, Law of Federal Income Taxation, § 49.1291 p. 298 (1982 Revision) which states:

The theory upon which the deficiency is alleged to be due is immaterial, and a deficiency asserted by the Commissioner will be sustained upon any theory of law under which the Commissioner can show that amount of tax to be due.

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Accordingly, at this juncture, **respondent's** recomputation is based upon daily cocaine sales of \$700 taking place from April 1, 1981, through the date of appellant's arrest March 26, 1982. While admitting that he received income from cocaine-sales, appellant contends that respondent's reconstruction of the income- was not accurate.

The California Personal Income- Tax Law requires a taxpayer to state specifically the items and amount of his gross income during the taxable-year. Gross income includes all income from whatever source derived unless otherwise provided in the law. (Rev. & Tax, Code, **§ 17071.**) 'Gross income includes-gains derived from illegal activities, including the **illegal** sale of narcotics, which must be reported on the taxpayer's return, (United States v. Sullivan, 274 U.S. 259 [71 L.Ed. 1037] (1927); Farina v. McMahon, 2 A.F.T.R.2d (P-R) ¶ 58-5246 (1958).) **Each taxpayer is required** to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. **§ 1.446-1(a)(4)**; former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25, 1981 (Register 81, No, 26).) 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, **§ 17561**, subd. (b).) 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., Vol. 15, 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.)

In the instant appeal, respondent used the projection method to reconstruct appellant's income from the illegal sale of cocaine. ^{8/} In short, respondent

^{8/} Respondent indicated that it, in part, relied upon the expenditure method to reconstruct appellant's income during the periods at issue. (Resp. Br. at 11,) This method seeks to reconstruct a taxpayer's income on the basis of his expenditures and estimated personal

(Continued on next page.)

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projected a level of income over a period of time. Because of the difficulty in **obtaining** evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., 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); Appeal of Burr MacFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has also been recognized, however,, that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the **burden of proving** that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to ensure that use of the projection method does not lead to **injustice by forcing the taxpayer to pay tax on income he did not receive**, the courts and this board have held that each assumption involved in the **reconstruction** must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr MacFarland Lyons, supra.) Stated another way, 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. (United States v. Bonaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States v. Dono, 428 F.2d 204 (2nd Cir. 1970).) **If such evidence is not forthcoming**, the assessment is arbitrary and must be reversed or **modified**. (Appeal of Burr MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., Mar. 8, 1976.)

In this appeal, the evidence relied upon by respondent in reconstructing **appellant's** income was derived from the results of the sheriff's investigation and statements made by appellant, Respondent determined that a pay-and-owe sheet seized at appellant's apartment indicates that his daily income from cocaine sales was \$700 and that, based upon statements made to his probation

8/ (Continued)

expenses. (Mundy v. Commissioner, ¶ 55,270 T.C.M. (P-H) (1955).) However, the August 31, 1903, report has relied only upon the projection method of income reconstruction so that there is no necessity to discuss any other method.

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officer, appellant had been in the business of **selling** cocaine from April 1, 1981, through his arrest on March 26, 1982. Based upon the above, respondent concluded that appellant had **\$189,000** in gross cocaine sales in 1981 and \$58,800 therefrom during the period January 1, 1982, through March 26, 1982. On appeal, appellant concedes that he was in the cocaine business, but contends that respondent's computation is in error. First, appellant appears to acknowledge that his pay-and-owe records indicate income of approximately \$700, but argues that the period which it covered was for one week rather than one day. However, as **noted above**, appellant's records indicate that he needed to make only **11** sales in order to generate cocaine sales of \$740. **The three surveillances** of his **residence** by Deputy Gordon indicated that an average of five persons per hour entered appellant's **residence**. Clearly, at that **rate** of traffic, **11 sales** must represent a daily figure rather than a **weekly** figure. Accordingly, based upon the **record before** us, we **must** find that respondent's reconstruction of cocaine sales at \$700 per day is based upon credible evidence.

Secondly, appellant contends he was in business beginning October **1**, 1981, rather than April 1, 1981, as respondent has determined. As indicated above, respondent's determination is **based** upon appellant's statements to his probation officer. Appellant now denies **having** made those statements. However, the probation officer's report **explicitly** states that appellant admits "he had been selling cocaine for approximately a year." (**Resp. Br.**, Ex. R, at 7.) **We** have no reason to doubt **the** veracity of that report. Accordingly, this **admission** appears to be credible evidence which would establish that appellant had been selling cocaine since **April 1**, 1981.

Based upon **the** foregoing, we have no **choice** but to find that respondent's reconstruction of appellant's income is based upon credible evidence and that **its** action must, therefore, 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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Gregory Lynell Wyatt for reassessment of jeopardy assessments of personal income tax in the amount of \$8,892 for the year 1981 and \$4,896 for the period January 1, 1982, through March 26, 1982, be and the same is hereby sustained.

Done at **Sacramento**, California, this 30th day of July , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

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

*For Kenneth Cory, per Government Code section 7.9