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BURDEN OF PROOF AND PRESUMPTIONS IN THE TAX COURT IN NET WORTH CASES INVOLVING CIVIL FRAUD

As is evidenced by the number of recent cases involving proof of civil tax fraud by the net worth method, this device is becoming increasingly popular with the Federal Government in enforcing its tax laws.

In a typical net worth case the Government, having concluded that a taxpayer's records are inadequate as a basis for determining income tax liability, attempts to establish an opening net worth or total net value of the taxpayer's assets at the beginning of a given year. It then proves increases in the taxpayer's net worth for each succeeding year during the period under examination and calculates the difference between the adjusted net values of the taxpayer's assets at the beginning and end of each of the years involved. The taxpayer's non-deductible expenditures, including living expenses, are added to these increases, and if the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the Government claims the excess represents unreported taxable income. The necessity of establishing the incompleteness or inadequacy of the taxpayer's records is not a condition precedent to the use of the net worth method. This method of determining income may be employed by the Government in its discretion.¹

The net worth method often results in an inaccurate statement of income or the placing of income in the wrong year and, at best, it produces only an approximation.² It has been said that the evidence in a net worth case is spun in a web of assumptions, inferences, and approximations, and jostled on a teeter-toter swinging and shifting the burden of proof.³ Since this method is inherently imprecise and indefinite in that the exact amount of the deficiency, if any, is almost never determined, burden of proof and presumptions play an especially important role in deciding the outcome of these cases.

ORDINARY DEFICIENCIES

In ordinary deficiency situations, the burden of proof in the primary sense is on the taxpayer, i.e., the taxpayer has the burden from beginning to end of the trial of proving that the proposed deficiency is erroneous.⁴ This burden should not be confused with the burden of

¹ *Holland v. U.S.*, 348 U.S. 121 (1954); *Meyers v. U.S.*, 134 F. Supp. 520 (Ct. Cl. 1955).

² 2 Mertens, *Law of Federal Income Taxation*, §1212, n. 50.

³ *Holland v. U.S.*, *supra* note 1.

⁴ *Joseph Moriarity*, 18 T.C. 327, *affd.* 208 F. 2d 43 (D.C. Cir. 1953); *Thompson Pottery v. Routzahn*, 25 F.2d 897 (N.D. Ohio 1927); see *Casey*, *Federal Tax Practice*, §7.3 for additional cases (hereafter cited as *Casey*).

going forward with the evidence, i.e., the burden of proof in the secondary sense, since the two burdens do not always coincide.⁵ Because the taxpayer stands as plaintiff in the Tax Court, it is not unusual that he should bear the burden of proof. But in addition to that burden, the taxpayer must also overcome a presumption of correctness which attaches to the Commissioner's determination of a deficiency.⁶ This presumption is not evidence itself, but merely shifts the burden of going forward with the evidence to the taxpayer.⁷ In the absence of such contravening evidence, however, the presumption is sufficient to establish the liability of the taxpayer.⁸

In order to rebut this presumption, the taxpayer must go forward with "competent and satisfactory" evidence, such "as would reasonably support a verdict for the recovery of money," showing the deficiency assessment erroneous.⁹ Once such evidence is presented, the presumption vanishes and no inference can be drawn therefrom.¹⁰ The presumption will also not obtain where the taxpayer can show that the determination of the Commissioner is arbitrary.¹¹ Thus in a net worth case, it has been held that the opening net worth must be established with some reliability, and any arbitrary or unrealistic amount assigned to opening net worth, or any of its components, will destroy the presumption.¹² The taxpayer need not show affirmatively the exact amount of his opening net worth, but only that the Commissioner's determination is without substantial support in the record.¹³ If, however, the taxpayer presents sufficient evidence upon which a proper deficiency may be assessed, he may be found liable for such deficiency. Thus in *Helvering v. Taylor* it was said:

"But, where as in this case the taxpayer's evidence shows the Commissioner's determination to be arbitrary and excessive, it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him."¹⁴

Therefore, in order to rebut the presumption of correctness at-

⁵ For examples as to when they do not coincide, see Casey, §7.3; Balter, *Rules of Evidence Applicable In Proceedings Before the Tax Court of the United States: Burden of Proof and Presumptions*, 6 *Marquette University Institute On Taxation Proceedings* 20 (1956).

⁶ *Pearce v. C.I.R.*, 315 U.S. 543 (1942); *Welch v. Helvering*, 290 U.S. 111 (1933).

⁷ *Hemphill Schools, Inc. v. C.I.R.*, 137 F.2d 961 (9th Cir. 1943); *J. M. Perry Co. v. C.I.R.*, 120 F.2d 123 (9th Cir. 1941).

⁸ *T. M. Stanton*, P-H 1947 T.C. Mem. Dec. para. 251.

⁹ *J. M. Perry Co. v. C.I.R.*, *supra* note 7; *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648 (1931); see also Casey, §8.7.

¹⁰ See note 7 *supra*.

¹¹ *Thomas v. C.I.R.*, 232 F.2d 520 (1st Cir. 1956).

¹² *Estate of Phillips v. C.I.R.*, 246 F.2d 209 (5th Cir. 1957); *Thomas v. C.I.R.*, *supra* note 11; see also *Gunn v. C.I.R.*, 247 F.2d 359 (8th Cir. 1957).

¹³ *Thomas v. C.I.R.*, *supra* note 11.

¹⁴ 293 U.S. 507 (1935).

taching to the deficiency determination by the Commissioner, the taxpayer must go forward with evidence tending to show that it is incorrect or arbitrarily established, but he need not go further and show the correct amount of the deficiency or that none was assessable.

Once the presumption is rebutted, however, the taxpayer has not necessarily sustained his burden, in the primary sense, of proving the deficiency erroneous. This he must show by a preponderance of evidence over whatever evidence the Commissioner may produce.¹⁵ In the case of *William Neth* the Tax Court found such preponderance of evidence from primarily the testimony of the taxpayer himself:

"Having heard the explanation of both petitioner and his wife of how they lived, worked, saved and invested, being convinced by their demeanor on the stand of the truth of the story as told, and having tested the mathematics of their explanation that the large deposits and expenditures were taken from past savings hidden in their home, we are convinced that petitioner's books were accurate in so far as they went and that the returns filed by petitioner for the taxable years accurately reflected his total income."¹⁶

Thus the taxpayer does not win by merely rebutting the presumption of correctness of the deficiency, he must also sustain his burden of proving the deficiency is not owing by a preponderance of the evidence.

CIVIL FRAUD

As has been stated above, in a proceeding involving only the assessment of an ordinary deficiency, the taxpayer has the burden of rebutting the presumption of correctness attaching to the determination by the Commissioner with competent and satisfactory evidence plus the burden in the primary sense of showing by a preponderance of the evidence that the determination of the deficiency is incorrect. In addition to an ordinary deficiency assessment the Commissioner sometimes asserts a fraud penalty as provided by Section 6653 (b) :

"If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment."¹⁷

As to the issue of fraud, the burden of proof is upon the Commissioner as indicated by Section 7454:

"In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate."¹⁸

¹⁵ *Woodward v. U.S.*, 106 F. Supp. 14 (N.D. Iowa 1952); *Thompson Pottery v. Routzahn*, *supra* note 4.

¹⁶ P-H 1949 T.C. Mem. Dec. para. 12.

¹⁷ INT. REV. CODE OF 1954, §6653(b).

¹⁸ INT. REV. CODE OF 1954, §7454.

The cases have held this to mean burden of proof in the primary sense.¹⁹ It is also well settled that the Commissioner must show fraud by clear and convincing evidence,²⁰ but he may rely on the entire record to sustain his burden of proof, i.e., in addition to his own affirmative evidence, all the pleadings, the total evidence in the record, and the cross-examination of petitioner's witnesses.²¹ Thus in a case where a fraud penalty is added to an ordinary deficiency assessment, both the taxpayer and the Commissioner bear a burden of proof in the primary sense, the taxpayer as to the ordinary deficiency, and the Commissioner as to the fraud issue. The taxpayer also has the additional burden of first overcoming the presumption of correctness of the determination of the deficiency by the Commissioner. The separability of the taxpayer's burden from the Commissioner's burden has often resulted in decisions in which the deficiency was sustained and the fraud addition disapproved.²²

What evidence is necessary to show fraud? This depends upon the necessary elements of fraud. There is some confusion, due to the impreciseness of the decisions, as to whether fraud involves one or two elements. It could be said that fraud presupposes a deficiency and is only a matter of intent, but it appears to be more consistent, at least it might be argued, that fraud is comprised of two necessary elements. These are 1) an understatement of income and 2) intent to evade the tax.²³ The Commissioner would like to rely on the presumption of correctness attaching to his determination of a deficiency to establish the element of understatement. And, since it has been held that large understatements of income over a period of years, keeping of no books, and no reasonable explanation given for the failure to report income is substantial evidence of fraudulent intent,²⁴ the Commissioner would also like to use the presumption of correctness to provide some evidence of fraudulent intent. But the Commissioner should be held to prove both elements by clear and convincing evidence unaided by the presumption of correctness as to either element. The mere failure to rebut the presumption as to the ordinary deficiency allowing such deficiency to be assessed should not be sufficient also as clear and convincing evidence that some understatement does exist. It

¹⁹ *Snell Isle, Inc. v. C.I.R.*, 90 F.2d 481 (5th Cir. 1937), *cert. denied*, 302 U.S. 734 (1937); *Gaines Williamson*, P-H 1955 T.C. Mem. Dec. para. 131.

²⁰ *Id.*

²¹ *Frank Imburgia*, 22 T.C. 1002 (1954); *J. William Schultze*, 18 B.T.A. 444 (1929).

²² *Hawkins v. C.I.R.*, 234 F.2d 359 (6th Cir. 1956); *Denny York*, 24 T.C. 742 (1955).

²³ See *Lipton, Trends in Tax Fraud Investigations and Litigation*, 34 *Taxes* 267 (1956).

²⁴ *Bryan v. C.I.R.*, 209 F.2d 822 (5th Cir. 1954), *cert. denied*, 348 U.S. 912 (1955); *S. S. Kashat*, P-H 1954 T. C. Mem. Dec. para. 94.

has been repeatedly stated that fraud is never presumed²⁵ nor is it to be lightly inferred.²⁶ It was said in *Davis v. C.I.R.*:

"It [fraud] is never imputed or presumed and the courts should not sustain findings of fraud upon circumstances which at the most create only a suspicion."²⁷

If fraud is never presumed, then the Commissioner should not be allowed to rely upon any presumption as to any element of fraud. It has also been consistently stated that fraud must be proven by clear and convincing evidence. The function of the presumption of correctness is only to shift the burden of going forward with the evidence, and once this burden is met, the presumption no longer obtains and no inference may be drawn therefrom.²⁸ Since the presumption itself is not evidence, it would seem inconsistent to allow the Commissioner the benefit of such presumption in satisfying his burden of proving fraud by clear and convincing evidence.

The foregoing analysis finds support in the recent Tax Court case of *Kroger Babb* where both an ordinary deficiency and the fraud addition were assessed, and the Commissioner relied upon the net worth method of establishing the deficiency. The taxpayer put in no evidence, in fact did not even appear. The ordinary deficiency was upheld but the fraud addition denied. The court stated:

"Respondent must prove that petitioner omitted a portion of his taxable income from his income tax return for each of the years involved, and that such omissions were due to petitioners fraudulent intent to evade taxes. To establish petitioner's omissions, respondent must prove income in excess of amounts of taxable income reported, and either establish a likely source from which unreported taxable income may have been realized, or negate possible non-taxable sources. The burden of proof is on the respondent and the evidence presented by him must be 'clear and convincing'."²⁹

And in a 1956 District Court case involving a refund suit by the taxpayer, the court charged the jury in part as follows:

"I therefore charge you that the government, on its claim of fraud, has the burden of proving by clear and convincing evidence that with reasonable certainty their computations of net worth at the beginning and end of each year is accurate."³⁰

The tax court has also stated that opening net worth in a fraud case must be established by clear and convincing evidence. Thus in *Frank Imburgia*, where the taxpayer claimed his opening net worth consisted of cash on hand of \$60,000 or \$65,000, the court stated the issues as:

²⁵ *Lusk v. C.I.R.*, 250 F.2d 591 (7th Cir. 1958).

²⁶ *Rogers v. C.I.R.*, 111 F.2d 987 (6th Cir. 1940).

²⁷ *Davis v. C.I.R.*, 184 F.2d 86 (10th Cir. 1950).

²⁸ *Hemphill Schools, Inc. v. C.I.R.*, *supra* note 7.

²⁹ P-H 1958 T.C. Mem. Dec. para. 79.

"Does the record properly before us establish, by clear and convincing evidence, that petitioner did not have \$60,000 or \$65,000 cash on hand, or any substantial cash on hand greater or less than those amounts as of January 1, 1945?"³¹

The above cases appear to recognize that there are two elements of fraud, an understatement and the intent to evade the tax, and that each must be proven by clear and convincing evidence.

There is a further reason why the Commissioner should be held to prove an understatement by clear and convincing evidence in a net worth case. This reason is that the net worth method is inherently imprecise and is of probative value only as facts from which an inference of an understatement may be drawn. The Supreme Court in *Holland v. U.S.* characterized the net worth method as being a matter of approximations and circumstantial inferences and warned trial courts that the taxpayer may be ensnared in a system which is difficult for a taxpayer to refute.³² This admonition has been heeded in civil fraud cases by the Tax Court.³³ And in *Fairchild v. U.S.*, a civil fraud case involving the use of the net worth method, it was said:

"Finally, what was said in *Holland v. U.S.*, a criminal case, is pertinent here because the same limitations inhere in the net worth method wherever it is sought to be applied."³⁴

Thus in cases where a fraud penalty is coupled with an ordinary deficiency assessment, and the taxpayer has failed to sustain his burden of showing that the deficiency is incorrect, the fraud addition should be assessed only if the Commissioner has shown by clear and convincing evidence that there has been an understatement of income and that such understatement was due to intent to evade tax.

The burden of proceeding first or going forward with the evidence as distinguished from the burden of proof in the primary sense, is influenced by the statute of limitations. An ordinary deficiency must be assessed within three years after the return was filed.³⁵ Where fraud is found, however, the three year statute does not apply and the addition may be assessed or a proceeding begun at any time.³⁶ In situations where both an ordinary deficiency and a fraud addition is assessed as to years within the three year statute, the taxpayer must proceed first, but he is not required to produce evidence rebutting the fraud allegation of the Commissioner.³⁷ In situations where the three year statute

³⁰ *Cleveland v. U.S.*, 4 P-H 1956 *Fed. Tax Serv.* para. 73, 111 (D.C. Ga. 1956).

³¹ *Supra* note 21.

³² *Holland v. U.S.*, *supra* note 1.

³³ *Kroger Babb*, *supra* note 29.

³⁴ *Fairchild v. U.S.*, 240 F.2d 944 (5th Cir. 1957).

³⁵ INT. REV. CODE OF 1954, §6501 (a).

³⁶ INT. REV. CODE OF 1954, §6501 (c) (1).

³⁷ *Snell Isle, Inc. v. C.I.R.*, *supra* note 19.

has run unless fraud is found, the Commissioner proceeds first with proof of fraud.³⁸

In cases where the statute of limitations has run unless fraud is established, the taxpayer will usually assert the bar of the statute of limitations in his petition. In this situation the Commissioner must proceed first with clear and convincing evidence of fraud in order to lift the bar of the statute. Once the statute is lifted, the presumption of correctness as to the exact amount of the deficiency obtains and the taxpayer must go forward to rebut this presumption as well as bear the burden of proof in the primary sense of showing by a preponderance of the evidence that the deficiency is erroneous.³⁹ The taxpayer will also produce evidence which will at least cloud the issue of fraud so that it cannot be found to be established by clear and convincing evidence. The taxpayer can test the quality of the Commissioner's evidence by moving for dismissal after the Commissioner's case in chief. By doing this, the taxpayer precludes consideration of any of his evidence, except pleadings, in the court's determination of whether the Commissioner has lifted the bar of the statute by clear and convincing evidence of fraud. If the taxpayer's motion for dismissal is denied, the Commissioner still has the burden in the primary sense, from beginning to end of trial, of showing fraud by clear and convincing evidence.

In cases where the three year statute of limitations has not run but only the fraud addition is contested, the Commissioner has the burden of first going forward with the evidence.⁴⁰ In these situations the Commissioner also has the burden in the primary sense since the taxpayer has conceded the correctness of the deficiency. The Commissioner must prove fraud by clear and convincing evidence and must sustain this burden throughout the trial.

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³⁸ Bryan v. C.I.R., *supra* note 24.

³⁹ Bryan v. C.I.R., *supra* note 24; H. H. Winer, P-H 1954 T.C. Mem. Dec. para. 254; see also Casey, §15.11.

⁴⁰ Ohlinger v. U.S., 219 F.2d 310 (9th Cir. 1955); Owens v. U.S., 98 F. Supp. 621, *affd.* 197 F.2d 450 (8th Cir. 1952).