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REPRESENTATION IN NET WORTH CASES

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Much has been said and written about the substantive law applicable to the net worth method,[1] but there has been relatively little comment about such practical aspects as the advisability of furnishing net worth statements, the consequences of refusing to furnish net worth data, and the methods of challenging a net worth determination. It is the purpose of this article to consider very briefly some of these problems which arise during representation in net worth cases.

THE NET WORTH METHOD—IN GENERAL

Ordinarily, deficiencies are determined by adjusting items of reported gross income or by disallowing deductions claimed by the taxpayer. The net worth approach, on the other hand, is a method of reconstructing income. It is premised on the accounting formula that an increase in net worth plus nondeductible expenditures, minus nontaxable receipts, equals taxable income. If the annual net worth increases and nondeductible expenditures are not accounted for by reported income and nontaxable receipts, the discrepancy is presumed to be current unreported income, and deficiencies are determined accordingly.[2]

The net worth method accurately reconstructs net income provided all pertinent facts are ascertainable and the net worth statements are consistent with the method of accounting employed.[3] The taxpayer may have difficulty, however, in recalling or establishing ownership of visible assets, such as real estate or securities, and it may be impossible for him to establish the amount of cash on hand. As a result, assets omitted from opening net worth, which are converted into other assets in later years, may be reflected as unexplained increases in net worth. Even though the total discrepancy between net worth increases and reported income does represent unreported taxable in-

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[1] See *e.g.* Avakian, *The Net Worth Method of Establishing Fraud,* PROC. NYU 11TH INST. ON FED. TAX. 707 (1953); Burns and Rachlin, *Trial by Net Worth,* 33 TAXES 121 (1955); Lipton, *Status of Net Worth Prosecutions,* PROC. MARQ. 5TH INST. ON FED. TAX. 224 (1956); Mills, *The Net Worth Approach in Determining Income,* 41 VA. L. REV. 927 (1955).

[2] BALTER, FRAUD UNDER FEDERAL TAX LAW 226 (2d ed. 1953).

[3] For example, if the cash basis of accounting has been properly employed, the net worth statement should not reflect business receivables or payables.

come, it may not be possible to apportion the unreported income accurately to the year or years in which it was in fact realized.

Notwithstanding the great danger of inaccuracies, the net worth method has been employed extensively. It provides an effective auditing technique, often disclosing unreported income which would not be discovered through an audit of books and accounts. In a routine examination[4] there is normally no occasion for the submission of net worth data to the examining agent. Should the revenue agent request net worth statements or pay undue attention to net worth items, fraud is probably suspected, and it is, therefore, imperative that the taxpayer obtain legal representation.[5]

Limitations on Investigative Authority

The various limitations on investigative authority are generally applicable in any tax case, but they may assume added significance when the net worth technique is employed. Not infrequently, net worth investigations cover a lengthy period. The difficulty of refuting the compilations, particularly for the early years, is often serious. Records may have been lost or innocently destroyed, and essential information may have been forgotten. As a result, efforts to show errors in the net worth statements, or to explain the understatements, may be fruitless, and the financial consequences to the taxpayer may be disastrous.

Although Section 7602 of the Internal Revenue Code provides a broad power to compel production of records and the appearance of witnesses,[6] the statute obviously refers to the production of records in existence at the time of demand and not to net worth statements which would have to be compiled by the taxpayer or his representatives.[7] However, this does not preclude a revenue agent from making an informal request for net worth statements. In the event that the taxpayer refuses to submit such statements, the agent may issue a

[4] The statement in the text refers to audits by the Internal Revenue Service. The Wisconsin Department of Taxation makes extensive use of the net worth method, and a request for net worth statements is not necessarily an indication that wrongdoing is definitely suspected.

[5] A well-known ceritfied public accountant has said that "an accountant does not serve his client if he does not insist on the need for legal counsel as soon as the use of the net worth approach is indicated." Mills, *supra* note 1, at 957.

[6] Section 7602 of the Internal Revenue Code of 1954 empowers the Secretary of the Treasury, or his delegate, to conduct examinations for the purpose of ascertaining the correctness of any return, making a return where none has been made, determining liability for tax, and collecting any such liability; and authority is granted to examine any books, papers, records or other data which may be relevant or material to the inquiry, to summon the taxpayer and other persons to produce books and records, and to take testimony under oath.

[7] See, however, Brody v. United States, 243 F. 2d 378 (1st Cir. 1957), wherein the Court of Appeals affirmed an order directing the taxpayer to submit weekly sworn statements of his expenditures. The Court probably was influenced by the fact that the taxpayer's counsel had conceded that this order, though modifying the summons, was reasonable.

summons calling for the production of all existing records bearing on net worth, and he may summon the taxpayer to testify from memory concerning these matters.

Whatever the investigative technique, the net worth examination is subject to the statutory and constitutional limitations on investigative authority which apply in any tax inquiry. Since these limitations have been the basis of extensive discussion in the past,[8] further treatment here would serve little purpose. Nevertheless, mention should be made of one investigative restriction which may receive unusual treatment in net worth cases. In general, years barred for assessment by the statute of limitations are not subject to examination unless the Commissioner can establish a reasonable basis for suspicion of fraud.[9] In net worth investigations, it has been suggested that normally barred years may be examined for the purpose of establishing a firm beginning net worth,[10] but this conclusion is of doubtful validity.

As in all tax investigations, the limitations imposed by the Fifth Amendment to the Constitution are particularly important. By invoking the privilege against self-incrimination under the Fifth Amendment, the individual taxpayer may decline to produce his records or papers or to testify under oath. The sweeping protection of the privilege in net worth investigations is well illustrated by the decision in *Vander v. United States,*[11] where the court upheld a taxpayer's blanket refusal to answer questions concerning his assets on the grounds that such answers might tend to incriminate him.

Objections by Third Parties

Net worth investigations frequently lead to records of various third parties, such as banks, brokers, the taxpayer's employer, and business associates. Such third parties may raise objections in their own behalf,[12] including the objection that the examination is barred by the statute of limitations or "unnecessary" within the meaning of the statute.[13] The Fourth Amendment prohibition against unreasonable searches and seizures is the basis for most objections by third

[8] For a discussion of these limitations see, Lipton, *Safeguarding Constitutional Rights in Tax Fraud Investigations,* 32 Taxes 263 (1954); Lipton, *Privileged Communications,* Proc. N.Y.U. 13th Inst. on Fed. Tax. 955 (1955); Lipton, *Record Keeping and the Privilege Against Self-Incrimination,* Proc. N.Y.U. 14th Inst. on Fed. Tax. 1331 (1956); Redlich, *Searches, Seizures, and Self-Incrimination in Tax Cases,* 10 Tax L. Rev. 191 (1955).

[9] Balter, *supra* note 1, at 157. For an excellent collection of cases and discussion of the apparent conflict concerning the showing required to justify examination of barred years, see In re Carroll, 246 F. 2d 762 (2d Cir 1957).

[10] Falsone v. United States, 205 F. 2d 734 (5th Cir. 1953), *cert. denied,* 346 U.S. 864 (1953).

[11] 119 F. Supp. 330 (E. D. Pa. 1954).

[12] See Note, *Constitutional Aspects of Federal Tax Investigations,* 57 Colum. L. Rev. 676 (1957); Note, *The Inquisitorial Powers of the Federal Government in Third Party Tax Investigations,* 41 Minn. L. Rev. 800 (1957).

[13] Martin v. Chandis Securities Co., 123 F. 2d 791 (9th Cir. 1942). Section 7605 (b) of the Internal Revenue Code of 1954 provides that no taxpayer shall

parties.[14] Recently, however, the Court of Appeals for the Ninth Circuit reversed two district courts decisions because the government had not established that records summoned from third parties were material or relevant to the inquiry.[15]

The benefits to the taxpayer may be substantial where legitimate objections are timely raised. Unfortunately, however, most third parties fail or refuse to urge possible objections. Of course, the taxpayer may move to quash a summons directed to a third party, but such attacks have been notably unsuccessful because of the extremely limited grounds on which they may be made.[16]

COOPERATION VS. NON-COOPERATION IN NET WORTH INVESTIGATIONS

The considerations which determine the degree of cooperation to be extended in a net worth investigation are similar in most respects to those which apply to any tax investigation. Although extensive treatment of this aspect would be desirable, this discussion will be limited to a few general remarks and some specific comments on the effect of cooperation in net worth cases.[17]

It is still a widely accepted belief that the tax evader who cooperates, and is willing to pay what he owes, will not be prosecuted. This false sense of assurance would soon disappear if it were commonly known that most tax prosecutions are based chiefly on evidence voluntarily supplied by the taxpayer.[18] Rather than serving to avoid prosecution, cooperation has generally provided the government with

be subjected to unnecessary examinations or investigations and that only one inspection shall be made of the taxpayer's books of account for each taxable year. The cited case holds that the corresponding provision of the 1939 Code (Section 3631) imposed a limitation on the government's power, and not merely a personal objection available only to the taxpayer.

14 See, *e.g.*, First National Bank of Mobile v. United States, 160 F. 2d 532 (5th Cir. 1947).

15 Local 174 v. United States, 240 F. 2d 387 (9th Cir. 1956); Hubner v. Tucker, 245 F. 2d 35 (9th Cir. 1957).

16 Constitutional rights cannot be invoked by the taxpayer in behalf of a third party. Zimmerman v. Wilson, 105 F. 2d 583 (3rd Cir. 1949). Nor can the taxpayer, in such a proceeding, claim the benefit of the statute of limitations or challenge the materiality of the inquiry. Schulman v. Dunlap, 105 F. Supp. 104 (S.D. N.Y. 1952); In re Upham, 18 F. Supp. 737 (S.D. N.Y. 1937); Cooley v. Bergin, 27 F. 2d 930 (D. Mass. 1928). It would seem however, that a proceeding to quash would be appropriate to prevent violation of a privileged relationship or to challenge an obvious abuse of process. *Cf.* Eckerling v. Helvering, 41-1 USTC par. 9220 (N.D. Ill. 1941) (unsuccessful proceeding to enjoin examination of a public accountant); United States v. Lipshitz, 148 F. Supp. 774 (E.D. N.Y. 1957) (court enjoined grand jury subpoenas in action brought by the taxpayer).

17 For a good discussion, see KOSTELANETZ AND BENDER, CRIMINAL ASPECTS OF TAX FRAUD CASES 57-61 (1957); Balter, *Should Your Client 'Cooperate' When Charged With Tax Fraud?* 29 TAXES 290 (1951); Platt, *Cooperation vs. Non-Cooperation in Tax Fraud Cases,* PROC. OF N.Y.U. 10TH INST. ON FED. TAX. 1305 (1952).

18 See, *e.g.*, United States v. Altruda, 224 F. 2d 935 (2d Cir. 1955); Lipton, *The Taxpayer's Rights: Investigation of Tax Fraud Cases,* 42 A.B.A.J. 325 (1956).

the evidence necessary to indict and convict. On the other hand, a policy of non-cooperation, wisely exercised, has saved many taxpayers from prosecution.

In net worth fraud cases, particularly, cooperation is often inadvisable. Accurate proof of the opening and closing net worth is crucial in establishing unreported income. Without the taxpayer's cooperation and admissions it is frequently difficult, if not impossible, for the government to establish a solid opening net worth, especially the item of "cash-on-hand". With respect to the closing net worth, cooperation may involve such significant admissions as the non-existence of liabilities or the taxpayer's ownership of assets held in the name of another. Obviously, cooperation may disclose investments and expenditures which could not otherwise be traced.

In most tax evasion cases based on the "net-worth method", the evidence needed to justify the recommendation for prosecution was supplied by cooperative taxpayers.[19] Such cooperation has also served to supply the government with evidence needed to meet its burden of proof with respect to the civil fraud penalty.

There may be important tactical advantages in avoiding the fool-proof net worth determination which results from cooperation with the investigators. Following a recommendation for prosecution, for example, it may be possible to discredit the entire investigation by pointing out important errors. Similar advantages may accrue in the settlement of the civil aspects. The judicial reaction to this situation is illustrated by the following comment in a recent Tax Court opinion:[20]

> This is one of the most deplorable records from which we have ever had to find facts or draw conclusions. The respondent's net worth computation of petitioner's income was in a constant state of flux from the time the revenue agent made his first report until the reply brief was filed.

The Tax Court refused to uphold the fraud penalties, probably because it was not satisfied that the understatements had been clearly proved by the government.

The advantages that flow from cooperation are confined primarily to cases where the taxpayer's innocence can be demonstrated by compiling net worth statements which are consistent with reported income.

CONSEQUENCES OF FAILURE TO SUPPLY NET WORTH DATA

One of the obvious consequences of failure to cooperate will be an attempt by the agents to obtain the necessary net worth data from

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[19] It has been aptly observed that "in practically every case in which a taxpayer has been convicted, the opening net worth had been established through admissions and actions of the taxpayer himself." Boughner, *The Use of the Net Worth Method as a Basis of Civil Liability*, PROC. OF MARQ. 4TH INST. ON FED. TAX. 16, 24 (1954).

[20] William E. Josey, 15 T.C.M. 758, 760 (1956).

other sources, such as banks, brokers, public records, etc. Usually, however, it is very difficult for the agents to prepare accurate net worth statements without the taxpayer's cooperation and access to his books and records.

If the agent is unable to reconstruct the net worth from other sources, he may issue a summons to the non-cooperative taxpayer to produce the desired books and records and to testify concerning net worth items. No summons will be issued, however, if criminal prosecution is contemplated.[21] In the event that a summons does issue, the taxpayer may invoke any of the available statutory or constitutional limitations on investigative authority as grounds for refusal to comply. Refusal may result in the institution of a proceeding in the district court to compel obedience, pursuant to the provisions of Section 7604 of the 1954 Code.[22] This procedure will not be employed if the government concludes that the refusal was justied, or that the requested information is not sufficiently important to warrant a court proceeding.

As suggested above, a net worth determination made without the taxpayer's cooperation is generally vulnerable to serious attack at the appropriate time. Of course, lack of cooperation may force the investigating agents to abandon the net worth approach.

Attacking the Net Worth Determination

Prior to the Supreme Court's decision in *Holland v. United States*,[23] an important issue in most net worth cases was whether resort to the method was justified when the taxpayer's books and records were ostensibly accurate and complete.[24] Although this contention may no longer be given any weight in criminal prosecutions,[25] there is some indication that the issue warrants consideration in civil cases.[26] In any event, a showing that the taxpayer's books and records are accurate and complete would tend to corroborate reported income based on those records.

Generally speaking, it is important in a net worth case to make every effort to minimize the apparent understatements of income, and, wherever possible, to provide plausible explanations for known

[21] ". . . it is contained in a directive in the manual of the Intelligence Unit, Internal Revenue Service, that you should never issue process to compel the production of records . . . [if there is] the possibility of recommending criminal prosecution . . ." Testimony of a special agent; United States v. Beard, (D. Md. 1954), Transcript, p. 681.

[22] The procedure is discussed in Lipton, *Procedural Aspects of the Subpoena Power*, PROC. N.Y.U. 16TH INST. ON FED. TAX. 1087 (1958).

[23] 348 U.S. 121 (1954).

[24] Avakian, *supra* note 1, at 713.

[25] Holland v. United States, *supra* note 23.

[26] See David Courtney, 28 T.C. 58 (1957), where the Tax Court outlines the showing required to establish that a net worth determination should be disregarded.

understatements in an effort to negative the inference of fraudulent intent. In endeavoring to accomplish these objectives, however, taxpayers' representatives frequently do their clients more harm than good. As will be noted below, timing is exceedingly important.

Minimizing the Apparent Understatements

Unless it is reasonably certain that the apparent understatements can be eliminated or reduced to amounts which are unsubstantial or readily explainable, it is generally advisable that this showing be deferred until the possibility of criminal prosecution has been eliminated. Otherwise, the net result is that the taxpayer thereby furnishes the government with clear-cut proof of understatements which could not have been established without the admissions.

The task of attempting to minimize or eliminate the understatements of income reflected by the government's net worth statements involves a detailed investigation in which both the accountant and lawyer should play a role. Usually, this aspect of representation in a net worth case is regarded as an accounting matter. Although much of the "digging" can best be done by an accountant, the task is basically a fact-finding job, not unlike that which is undertaken by lawyers in many types of cases. A discussion of the techniques that may be effectively employed, and the precise role that the accountant and lawyer should undertake, is beyond the scope of this discussion. However, it is to be emphasized that the lawyer should actively direct the investigation and that he should personally inspect all pertinent records. Moreover, the investigation should not be confined solely to the determination of the correct net income, but should be utilized to uncover every bit of evidence that has any bearing on the question of intent. This makes it imperative that the lawyer participate very closely.

Often, correction of errors in a net worth determination results only in a shift of the understatement from year to year, rather than in an overall decrease. The shifting of the understatement may be helpful to the taxpayer in some cases, harmful in others. Great care must be exercised in determining the appropriate time to disclose information that may be harmful to the taxpayer.

Attacking the Fraud Determination

To sustain its burden of proving fraud, the government must establish both an understatement of income and an intent to evade tax.[27] Obviously, the first step in attacking a fraud determination is an attempt to eliminate the understatements or to reduce them to amounts which are not substantial. This is not usually possible in net worth cases; but it is frequently possible to successfully contend

[27] Holland v. United States, *supra* note 25.

that the government will not be able to carry its burden of proof on the fraud issue.

In criminal cases, it has been readily apparent that the government must prove that income was understated. There has been some confusion in civil cases, however, which makes it desirable to review briefly the principles governing burden of proof in civil fraud cases.

In proceedings before the Tax Court, the burden of proof with respect to deficiencies rests upon the taxpayer, but the burden of proving fraud is placed upon the Commissioner by statute.[28] If assessment is not barred by the statute of limitations, the deficiencies will be upheld unless the taxpayer adduces proof sufficient to overcome the presumption of correctness attaching to the Commissioner's determination. If the deficiencies are barred, the taxpayer has no burden unless and until the Commissioner establishes fraud, in which case he must meet his normal burden of proof.[29]

In order to prove an understatement of income in a net worth case, the government must establish opening net worth, including the item of cash-on-hand, with reasonable certainty. The taxpayer's failure to disprove the government's opening net worth may require a holding against him with respect to deficiencies not barred by the statute of limitations, but should not be accepted as tantamount to affirmative proof sufficient to carry the government's burden on the fraud issue.

Relatively few decisions have clearly outlined and observed the requirements of the burden of proof in civil fraud cases.[30] Frequently, the courts have assumed that an understatement of income had been established where the record may have warranted only the conclusion that the taxpayer had failed to carry his burden of proof as to the deficiencies.[31] Occasionally, however, the correct result has been reached on the ground that the Commissioner failed to prove "fraulent intent", though in reality an understatement of income had not been established.

Although the need for the required proof has not been clearly enunciated, there has been a definite trend recently in the appellate courts to reject arbitrary determinations by the Commissioner of Internal Revenue with respect to opening cash-on-hand.[32] These decisions stress the necessity of an acurate determination by the

[28] INT. REV. CODE OF 1954, §7454(a). The same rule prevails in the district courts, though there is no specific statute applicable. Ohlinger v. United States, 219 F. 2d 310 (9th Cir. 1955); Hargis v. Godwin, 221 F. 2d 486 (8th Cir. 1955).

[29] See Lipton, *Recent Civil Fraud Cases—Problems of Burden of Proof*, 31 TAXES 110 (1953), and Lipton, *Trends in Tax Fraud Investigations and Litigation*, 34 TAXES 267, 275 (1956).

[30] The cases prior to 1956 are discussed in the articles cited in footnote 29. For a recent, well-reasoned decision see Lureana, 31 T.C. No. 37 (1958).

[31] See cases discussed in articles cited *supra* note 29.

[32] Thomas v. Commissioner, 223 F. 2d 83 (5th Cir. 1955); Rubino v. Commis-

Commissioner and require that the record contain affirmative proof establishing opening cash-on-hand.

CHALLENGING USE OF ESTIMATES

In attempting to prove an understatement of income on the net worth basis, estimates and approximations cannot take the place of proof in meeting the government's burden. This, in substance, is why the item of cash-on-hand has caused the government considerable difficulty. Frequently, other estimates and approximations are found in a net worth determination, and the taxpayer's representative must be alert to make effective use of any such weakness in the government's case.

Items which are often estimated include living costs, inventories, receivables, and payables. A recent Tax Court case serves as an apt illustration of the difficulties which the government may encounter in relying upon approximations in carrying its burden of proof. In *W. A. Shaw,*[33] the Commissioner had been able to substantiate inventories and receivables at the opening and close of the net worth period, but had no proof of the amounts of these items at the end of the intervening years. With reference to this approach, the Tax Court commented as follows:[34]

> Obviously, this procedure results in estimates which are, at best, crude approximations. If this case involved only deficiencies, and the burden of proof were entirely upon petitioner, we would have to sustain such estimates, for petitioner has done nothing to rebut them. . . . But the burden of proof rests upon respondent in the instant case since the deficiencies for the years 1941 through 1946 are barred by the statute of limitations if fraud is not proved for such years. . . .

In support of its holding that the imposition of fraud penalties could not be sustained, the Tax Court added:[35]

> The basic fallacy in respondent's approach to the merchandise inventories and accounts receivable is that there are no grounds for assuming that they increased in the rigid, precise fashion of an arithmetical progression. The increase in these assets may have occurred entirely in one year and the fraud might have been consummated solely in that year. In such a situation, there is no justification for spreading the deficiencies and fraud penalties over a period of years. One of the fundamentals of our income tax system is the annual accounting concept and, although the net worth method of determining an individual's taxable income may result in some slight deviation from this because of the approximations inherent in a net worth computation, there is no authority in the Code for a complete disre-

sioner, 226 F. 2d 291 (6th Cir. 1955); Kashat v. Commissioner, 229 F. 2d 282 (6th Cir. 1956); Thomas v. Commissioner, 232 F. 2d 520 (1st Cir. 1956).

[33] 27 T.C. 561 (1956).

[34] *Id.* at 569.

[35] *Id.* at 570.

> gard of the principle that each year is a separate taxable unit. Where the issue is fraud, we cannot assume that such fraud occurred in each of the years in issue rather than solely in one.

DEMONSTRATING THAT UNDERSTATMENTS WERE NOT FRAUDULENT

Although the government has the burden of proving intent in a fraud case, the Commissioner has rarely hesitated to impose fraud penalties solely upon the basis of understatements of income. All too frequently, the Commissioner's position has been approved by the courts, even though there was no evidence of concealment or other indicia of fraud.[36] Therefore, with respect to understatements which the Commissioner can establish by competent proof, every possible effort should be made to provide explanations which negative the inference of fraud. Explanations should not be attempted where the government cannot clearly prove that income was understated. In his haste to provide explanations, the taxpayer frequently makes admissions which the government needs to carry its burden of proof. In some cases, however, it is possible to provide "alternative" explanations, without conceding that income was understated.

In fraud cases involving specific adjustments to income, the importance of establishing explanations for the understatements has always been apparent. In net worth cases, however, there has been a tendency to concentrate on the net worth statements. Actually, since the net worth method serves to conceal the cause of the understatements, explanations may be of even greater importance than in a specific adjustment case.[37]

Frequently it is possible to demonstrate that the understatements are attributable, in whole or part, to technical adjustments, such as the deduction of excessive depreciation or the improper deduction of capital expenditures. Sometimes the understatements may be due principally to a change in the accounting method. Thus, the inclusion of business receivables in the net worth of a taxpayer who has erroneously employed the cash basis in reporting income will produce understatements of income. The explanation, however, should serve to avoid the imposition of fraud penalties.

With respect to deficiencies which are due to technical adjustments, it may be possible to successfully challenge a fraud charge by demonstrating that the understatements resulted from mistakes, inadvertence, carelessness, poor record-keeping, or lack of adequate controls in the bookkeeping system. This is by no means a comprehensive list, but a full discussion of the many factors which are significant in attacking the imposition of fraud penalties is beyond the scope of this article.

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36 See Lipton, *supra* note 29.

37 Avakian, *Proper Handling of Potential Fraud Cases*, PROC. OF THE 7TH TULANE TAX INST. 349, 369 (1958).