1963

The Preparation of a Civil Net Worth Case for Trial - The Private Practitioner's Viewpoint

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The Preparation of a Civil Net Worth Fraud Case For Trial — The Private Practitioner's Viewpoint.

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From the private practitioner's point of view, the preparation of a civil net worth fraud case for trial runs the gamut of law practice. The preparation for trial begins the day the special agent drops by to pay a visit to your client, or perhaps even before. Whereas the criminal features of a fraud case are handled by the U.S. Department of Justice, and the civil phase by counsel of the Internal Revenue Service where the U.S. Tax Court route is taken; a client will normally not desire the luxury of two counsel preparing separate criminal and civil cases concurrently. As you know, a taxpayer may pay the assessed taxes, penalties and interest and file his claim and subsequent suit for refund in the appropriate U.S. District Court or the U.S. Court of Claims. Since the imposition of fraud penalties under Section 6653(b) IRC (1954) in the amount of 50% of the tax, plus interest (frequently for 15 or more years back) results in a tremendous sum, we will consider today the Tax Court route, which seems to be the more frequent one. This discussion is restricted to the net worth type of fraud case, although many of the same comments would apply to a bank deposits fraud case in which income was reconstructed through bank statements and the deposits thereon, or certain other methods. As you all know the net worth method presupposes an incorrect reflection of reported income with the concomitant lack of supporting books and records. In other words, if the profit and loss statement is thrown out, a balance sheet will be adopted or re-created by the government so that income may be computed as follows: "What you own" minus "What you owe" equals your "net worth". And if your "net worth" increases next year, you must pay tax on the increase in "net worth."

Special Agents, CPA's and Fees

When a special agent comes into the case, a red flag immediately goes up and any intelligent taxpayer will immediately consult an attorney. A special agent has credentials which reflect that he is a representative of the Intelligence Division and he usually works in concert with another agent as a team. When the special agent comes in, there is an extremely good chance that criminal fraud has been considered, as well as civil fraud. This means first that there is the threat of a criminal prosecution, and second, there is the threat of financial ruin which may well be caused by the staggering penalties and interest which will come into play. The

tremendous problem arises where the 6 year statute of limitations is cast aside to go back to 1940 or 1945 in order to force the re-creation of a person's entire financial life. In these cases, it is customary to add a 50% fraud penalty under Section 6653 (b) of the Internal Revenue Code of 1954 or Section 294(d)(1)(A) IRC (1939) which permits this where there is fraud alleged. This is an instance where the government can go back beyond 6 years even if a return has in fact been filed. Customarily the Internal Revenue Service will have one or more notice of deficiencies, usually the first one for the later years. Then when you begin negotiating for these years, you may well receive a second notice of deficiency for the earlier years. This just seems to be part of the game. Nevertheless, when the special agent gets into the case, we know that the government feels that there is something unusual and there may be too many Cadillacs and Imperials that have supposedly been purchased on the income reported; and we must immediately advise the taxpayer what he is involved in, what his rights are, and what course of action he should follow.

Before undertaking the case, there should be an immediate discussion with the taxpayer on the subject of Certified Public Accountants. You must first advise the taxpayer that he must have, if he does not already, a Certified Public Accountant who is ready, willing and able to work hard, and to appear in court and testify if necessary, to make a good appearance, and to have imagination. I am sure that most CPA's, if not practically all of them, will make excellent witnesses. But if there is any reticence on the part of any CPA to testify in court, he should immediately advise his client of this fact and arrange for somebody else in the firm to work on the team. Occasionally you will find a lawyer who is a CPA and a lawyer. Do not let this man act in a dual capacity because he may well have to be a witness in the case, and you may run into some problem in the question of the confidential nature of the communications. As you know, an accountant's communications are not necessarily privileged, as a matter of law. You should then arrange for a conference with the CPA in order to advise him what information you need, and, if you have reached that stage, the theory under which the case will be developed.

On the subject of fees, remember that you will spend many, many hours on a fraud case. You must be in a position to evaluate the case. It might be well to use an hourly charge during the investigation stage until you see how the case shapes up before you discuss any question of a possible partially contingent fee. If you have a taxpayer who will be wiped out financially if the case is successful, you must remember that his debt cannot be discharged in bankruptcy, and you must take this into consideration in charging the fee and determining the amount of time which you will be in a position to spend on it. Be very careful in esti-

mating the time if you set a flat fee because if you keep time records you may find out at a later date that you have been unrealistic. The Norfolk-Portsmouth Bar Association has enacted a reasonable minimum fee Schedule in tax matters which might serve as the basis of a guide in areas which do not have such a detailed schedule. This is not meant to be mercenary, however this is a crucial part of the case and should be firmly understood between the client and the attorney. A partially contingent fee may be in order in an appropriate case, particularly where a theory contrary to the net theory has some basis in fact.

Assuming that the fee arrangement has been satisfactorily set and a CPA has been engaged, then what do we do with the special agent? At the outset, it should be emphasized that the government will in all probability try to resolve the criminal case before the civil case is determined. The reason for this is obvious. If a plea of guilty, a nolo contendere plea, or a favorable verdict from a jury or judge can be obtained by the government in the criminal case, then evidence of this will be submitted for introduction into evidence in the civil case. Although the civil case is concerned with the amount of tax due, this becomes a lethal weapon in many cases, when the fraud penalty itself is imposed. At the present time, a nolo contendere conviction may be introduced into evidence, although I personally disagree with this procedure. The present cases generally hold that the judgment order reflecting the plea of nolo contendere can be introduced into evidence by the government in a Tax Court Case. *(Wm. A. Prater et al 53,263 P-H Memo T.C.)* Counsel must be prepared to handle the criminal case all the way up through the criminal division of the Department of Justice and in conference attempt to persuade the Department of Justice that the criminal action should not be taken.

Before the criminal case is disposed of, the all important question must be answered regarding whether or not to cooperate at all with the special agent, or for that matter, any other agent in the case. This is a most crucial decision, and one which may make or break the case. You must be extremely careful in your dealings and negotiations with the special agent; the special agent will take careful note of anything that counsel says or anything that the taxpayer says, and in my experience with the Internal Revenue Service I have seen attempts to introduce into evidence any statement which is made by counsel to the special agent as well as by the individual himself. On some occasions this has been successful. In other words, be cautious of the special agent because he is not really in a negotiating position. He is a fact-finder and will disclose anything he has received from anybody in court. You are not in the usual "without prejudice" situation which is the rule rather than the exception among legal brethren. The special agents are usually extremely aggressive, but they have a job to do. Although each case must be

evaluated on its own merits before a decision can be made on cooperation or non-cooperation, a reasonable length of time should be requested in order that the CPA and the attorney may immediately get complete financial information from the client. If it is clear that the government is in "left field" after reviewing the accountant's information, and that there are facts and figures to back this up, it might be well to call in the special agent and a court reporter, and lay the entire picture on the table before him. If, however, there are some gaps in the case, which is the more usual case, then there is very little that can be gaind by this procedure. Regardless of what the ultimate decision is, counsel should maintain a most courteous relationship with the agent; and he can always ask the special agent to give him a list of those specifis items which he is interested in and then make a decision as to those which will be given to him. The special agent of course will go around to the various banks in the area, check the court records to determine what was owned in the way of real property and personal property, check around with friends and determine the person's propensities towards spending and any old financial statements given banks or creditors and he will make a rather exhaustive investigation. If you advise your client not to cooperate with the special agent, it might be wise to call the agent and give him a written statement as to exactly why you do not see fit to cooperate. A point which I intend to discuss later is that in certain cases, the special agents may overlook those books and records of a business which are available (which might well be sufficient to establish income under the customary means set forth in the Code). It might be well to tell the special agent that you will cooperate with him in any respect in giving him information under your theory of the case, namely that income was computed properly, and then go to great lengths to convince him that your theory is correct. You may not accomplish much by this, but when the special agent takes the stand and testifies that the taxpayer did not cooperate with him, then this evidence could perhaps be used in rebuttal. Be extremely careful what information is given to the Revenue Agent, and try to have your CPA getting information just as rapidly and working just as hard as the special agent. You will quite frequently find that the government spares no expense in sending additional men down if necessary to build up a net worth case. If you do intend for the client to make a full and complete statement, I would call your attention to the recent case of *In re: Neil, nos. 429-431 U.S. Dist. Ct. S.D. W. Va. 209 F. Supp. 76 (1962),* in which it was held that a taxpayer could have a government court reporter present at the time that the statement was made. I would highly recommend this because although a written statement is frequently signed and sometimes unfortunately before the client has seen fit to call an attorney, I have seen an instance where an agent would intersperse additional comments on the

stand, and a court reporter's transcript of the hearing might tend to keep such gratuitous statements down.

The Pleading Stage

Let us now assume that the case has been thoroughly investigated by the special agent and your CPA and that you, as attorney, have been right on top of the case. Let us also assume that the criminal matter has been disposed of. In talking about the jockeying for position on the criminal and civil cases, remember that you are at a distinct disadvantage as a taxpayer's representative. In Virginia, and in Richmond, there is usually only one calendar a year for the Tax Court and I have found that it is quite easy for the Government to obtain a continuance. A one year's delay on the part of the Government will quite frequently result in the criminal prosecution being concluded early, so you can almost assume that this will be accomplished. About the only way that you can fight this is to move the court to transfer the case back to Washington or some other place to try to get an earlier disposition. Don't bank on this however. Remember it's to your advantage to try the case as soon as possible in order to stop the running of interest. These cases sometimes drag on for years.

The taxpayer will then receive (or may have received) a 30 day letter to which he can protest. Without going through all procedures, I will suggest that you not protest to the 30 day letter unless you have an extremely good case. You will just be wasting time, however this must be decided in each case. After this will come the 90 day letter which will carry with it the agent's computations which will usually have a lot of penalties tacked on and in addition to the 50% fraud penalty, you will practically always also run into the penalty for failure to file a declaration of estimated tax.

Back when the net worth method first started, the government gave very scant information. Through a series of cases, the government has been forced into the position to give you not only a full and complete net worth statement, but schedules to back everything up. I say forced you because if you don't get the schedules on the 90 day letter, you can call for them in your pleadings by motion to make more definite and certain and probably the Commissioner will be required to give the schedules to you *(Licavoli* v. *Comm.* 15 TCM. 862, and 15 TCM. 998, cited in *Tax Court Practice,* by Loyal E. Keir, *American Law Institute,* p. 75). I have found that in the Richmond area, the procedure has been to give you everything including the proverbial kitchen sink in the form of schedules to back all these statements up, if not in the 90 day letter at least in their answer to the petition. A petition should be drawn up and filed in the Tax Court within 90 days of receipt of the "90 day letter" and this petition should be carefully drawn and should be as

brief as possible consistent with the facts to set forth your "defense". I think if you will treat the 90 day letter as an initial pleading and consider your petition as a "defense", you will find yourself in a better position because in effect the burden is upon the taxpayer to prove that the Commissioner erred as to the deficiency. A very important exception however, is that the burden is upon the Commissioner to prove the fraud for those years in which there is fraud alleged. This is important to remember because fraud is the "wedge" to open up years which are more than 6 years old and customarily barred by the statute of limitations. (As a matter of procedure however, during the course of the trial, the taxpayer usually carries the laboring oar and presents his case first, even though there may be some years in which the government has the burden of proof by virtue of the fraud).

After the petition is filed and an answer is filed to the petition, there is frequently a squabble in the pleadings over how much more the taxpayer must disclose. The case of *Licavoli supra* (in reverse) is very important along these lines. It is felt that the taxpayer is placed in a very difficult position where his theory of the case is that the government should not have resorted to the net worth method to start with. The government quite frequently tries to force net worth figures from the taxpayer in any event. It may be to your advantage to go on ahead and prepare the net worth statement and it may not. In any event, if you decide that it is not, you must study the rules of the Tax Court and the cases very carefully to make sure that you are not subject to a motion to dismiss for failure to respond to those figures which the court orders you to give.

I am not going to dwell on the pleading stage because this could constitute a separate subject. Just remember that when the government sets up new matters in an answer, then it is the taxpayer's duty to reply to these items, and in the event that he fails to reply, then there are problems which arise there and you may find yourself out of court by failing to reply. So you must be very careful to stay on top of the rules of the Tax Court. An interesting example of this occurred about a year ago when I was in Washington to argue a motion for taking of depositions in a case. (By the way, the Tax Court is very reluctant to grant the taking of de bene esse depositions in a net worth fraud case because of the fact that the credibility of witnesses is involved. This may be so even though witnesses live hundreds of miles away). In the example that I had in mind, an attorney had flown up from Miami on a motion in effect requesting a discovery deposition and there was a motion which was argued just before him in which the court stated to the counsel, "your request for depositions is in effect a request for discovery depositions, which as you know, Mr. So & So, are not permitted under the rules". When the Miami lawyer was called upon to argue his motion, he meekly

stood up and said that he guessed that his motion had been resolved to his detriment in the former motion and he turned around and flew back to Miami. The Tax Court does not permit discovery and this should be made crystal clear to everyone and is apparent upon a reading of the rules.

Settlement Stage

After the parties are in issue, the most difficult portion of the case ensues. This is the actual attempt at settling the case before trial. The entire Tax Court machinery is geared towards settlement. Most of your Tax Court cases are in fact settled before trial. Stipulations are encouraged. The settlement conference area is one that perhaps could bear improving on, and is found in Revenue Procedure 60-18. To make a long story short, the taxpayer and his representative receive a letter from a representative of the Appellate Division. The representative of the Appellate Division informs the taxpayer and his representative that he may have a conference, let us say in Richmond, at which the Regional Counsel in charge of trying the case and the agent of the Appellate Division will be present. There are good reasons for by-passing such a conference in a particular case, however let's assume that a conference is in fact held. This is done in the great majority of cases. The taxpayer should prepare himself well for the conference and obtain affidavits, statements, schedules, and his CPA's complete cooperation prior to the time that the conference is held. It is not recommended that the taxpayer himself be there at this conference. Invariably, the representative of the Appellate Division is an accountant. He sees a paper case. The lawyer representing the taxpayer sees a paper case but he also sees his client as a potentially good witness perhaps; and he often sees a deficiency in the quantum of evidence necessary to lay a foundation for the introduction into evidence of many of these paper figures. The government's representatives take the attitude that the taxpayer should divulge its case to them and this gives them an opportunity to hear the taxpayer's case. Many times, the taxpayer does not have the same benefit of the government's case. The Attorney for the Government may see the hazards of litigation, however it is not clear on occasion as to the valuation of these hazards by the representative of the Appellate Division. For instance, if the taxpayer is truly illiterate, and apparently is in fact genuine in his efforts but has just frankly been sloppy, you are liable to run into such statements as "he was dumb as a fox". This of course is all part of the game, however it is felt that insufficient weight may on occasion be given to the actual credibility of certain witnesses who might not be particularly brilliant. This frequently happens in net worth fraud cases. It seems as though frequently more is accomplished by letting the CPA and the representative from the Appellate Division "go at each other's throats" than it is for the lawyers to argue with their accounting counter-

parts. Remember that effectively, the Appellate Division and the Regional counsel have for all practical purposes, joint control of the case.

If the case is not settled at this stage, it is sometimes possible to have an additional conference. If neither conference works, then the parties get ready for trial.

Stipulation

The next step is a stipulation conference between attorneys in which it is intended that all facts which are capable of stipulating be covered. This is generally arranged at the request of the counsel in charge of the case for the government. I frankly think that in some cases it might be best to have the stipulation conference take place before the conference with the Appellate Division. Then there would be no question as to those facts which were stipulated to and a decision would have to be made on certain issues. This is simply food for thought and the present procedure is distinctly different. The stipulation in a net worth case is important because if you stipulate to too many items being in existence, in a particular year, then you may minimize your attack.

If you do stipulate certain figures which are shown on the government's net worth statement and if your defense to the case is that the income as reported on the return was basically correct, it is important that you insist on a stipulation as to those figures which showed up on your client's return. (In other words your own profit and loss figures.) These figures will not show up on the net worth statement. You may find that the government at this stage of the game will say that they did not have the opportunity to audit those books and that in effect they just went in and "net worthed" the man. This is the time to make the books available to the government, to go down and see how much the purchases were, the sales were, then permit a full audit and then tell them quite politely that unless they stipulate to those figures which are consistent with your theory of the case, you will not stipulate to those figures which are agreeable to their theory of the case. If you follow this procedure, then the Tax Court judge may not criticize you any more than the government for failing to stipulate to those items which are capable of stipulation. This is stated even in view of the tightening stipulation procedures *Rule 31(b) (5) Tax Court.* I cannot emphasize too strongly the fact that in many cases, you may develop a theory in a case which can conceivably hold water and which is consistent with the Revenue Code and which could be more profitable to the taxpayer than the net worth theory. In short, please tax your imagination to the fullest when you enter the stipulation conference and insist on those matters which need to be stipulated because it is here that you may need evidence at the time of trial and evidence which would be very difficult to prove. It is also at this particular stage that you may be able to convince the gov-

ernment counsel that their case is "strong on suspicion and short on proof!"

Specific Items

I have deliberately held back the discussion of specific items in a net worth case until after the stipulation stage. I would say that with a customary net worth statement, there are certain items that can be attacked at any stage in the proceedings and are not limited to this stage immediately before trial.

The first specific item which I would like to mention is the continual bugaboo of cash on hand. Usually, the revenue agent will attempt to get a commitment in writing from the taxpayer as to how much currency on hand he had as of a particular date. Believe it or not, there are still a number of people around who maintain a substantial amount of cash on hand. Tax Court cases have upheld substantial amounts. When they try to pinpoint how much they have had at a particular date, it is something difficult to establish. There is sometimes not even any cash listed when the taxpayer has made a statement that he had several thousand dollars on hand. This is allegedly done because there are no records to back up the statement. In other words, everything that can be found and tied down by way of records is listed on the statement but the taxpayer's own statement concerning cash is sometimes excluded. My experience has been that once the special agent obtains a statement from the taxpayer, whether it is favorable or unfavorable to the government's case, he might not check it out to the fullest extent possible. If the taxpayer kept cash in an old box or under a mattress or in a hole in the wall or in a trunk or in a money vault or a safety deposit box, then the question of corroboration becomes necessary. The first thing that the attorney can do is to cross examine a client vigorously to determine whether or not he feels he is telling the truth. The next thing he can do if the issue becomes important, is to arrange for the client to take a lie detector test. *(Zimmerman* v. *Comm* (PH T.C memo #60,257) (1960)—for an excellent discussion of this case see Schwab, *The Civil Aspects of the Net Worth Method,* Vol. 3, No. 1, page 65, et seq., *William & Mary Law Review 1961).* If the lie detector test results favorably, it could conceivably be used in settlement conference or as was done in the Zimmerman case, it could be offered into evidence (even though it appears that the present rule seems to be that the result of a lie detector test is not admissible in the U. S. Tax Court.) There should be no harm in attempting to justify the use of a lie detector test (where you have a judge and not a jury) in a net worth case where the individual's truth is in issue. If the petitioner lived in an old dingy room or saved his money in a parsimonious manner, get pictures of the room, get people who can testify to his habits, get people who know that he dealt in cash and remember specific instances upon which he dealt in

cash, ask the special agent on the stand why he did not go to the room and examine it and go to the box and look at where the money used to be kept or perhaps still is kept and do whatever is possible to corroborate the case. The case of *Damski* v. *Comm.* (1957) 29 TC 1 is the case of a Lithuanian immigrant who had $70,000 in a money belt on his person when he came from overseas and in that particular case the Tax Court upheld the cash that was on hand. (Various people traced it through paper bags, etc.) The basis of assets frequently comes into play and of course where the case must be carefully built by the government is the beginning net worth figure. These figures must be attacked if at all possible because if there is any decrease in an asset caused by sale, such as a store building and lot in the amount of $15,000, then that is a decrease in net worth for the particular year which inures to the benefit of the taxpayer. You must be very careful in your investigation of this. If there is and has been a substantial amount of cash on hand and if assets such as stocks or new banks accounts have been created by cash money, then it is good to see that this is traced and how it was done. This is a painstaking matter and requires a statement of application of funds which we will discuss later.

Personal living expenses is another item which can be and frequently is an arbitrary figure. A schedule should be made up, in which the individual lists his living expenses right on down to tooth brush and tooth paste. This should be made in concert with the Certified Public Accountant. An attempt should be made to have the CPA testify to this on the grounds that he obtained it from your client. If this is objected to, then the client should review the statement prior to the time he takes the stand and testify to these figures, and then you should have the CPA take the stand and attempt to tie these figures together. The Judge might prefer that this be done rather than handled in brief.

At this stage it is fair to say that there are usually one or more items in one of the middle years that somehow or another stick out like a sore thumb and which you can attack on the net worth statement. You may find it helpful to pay the tax for one or more of the middle years and go into the Federal District Court on a suit for refund. This may tend to break the continuity of the presentation in a particular case.

And in connection with the establishment of any figures which require testimony, it is important that the witnesses be completely truthful, because the credibility of the witnesses is an all important factor in the determination of fraud, which to a great extent is subjective. There is some authority for the proposition that a continual unexplained understatement of income in and of itself constitutes fraud. You will hear this over and over again from the revenue service. *Lias* v. *Commissioner.* (24 TC 280) In the *Lias* case however, the facts are that *Lias* was a gambler and the deficiencies were well over $100,000 in tax for *each* of

the years in question. In other words, your continual understatement cases generally involve a lot of money. Watch out however for the recent case of *Bahoric* v. *Comm.* P-H#57005-TC Memo 1963-333, in this regard.

When you are investigating a case, be very, very careful to see if there is any specific transaction which is fraudulent in and of itself. When you find this out, be wary because this should affect your valuation of the case. Remember, if fraud is proved, *for any item or any transaction in a taxable year,* then the whole year is tainted and the fraud penalty applied to the entire deficiency and not just to that portion which was attributable to the fraud.

Burden of Proof

One of the most difficult things to convey to those charged with the settlement of the case is the fact that fraud must be proved by clear and convincing evidence. It is felt that the tax court judges who were trial lawyers, realize the heavy burden of proof required, however those members of the administrative arm of the Revenue Service (as contrasted to the legal members) with their paper cases may not always realize this burden of proof and its applicability to the specific case at bar. I think it is the job of taxpayers' representatives to emphasize and clearly delineate in a border line case where the government is unable to establish its burden of proof by clear and convincing evidence. In conference it might be well to discuss the difference between clear and convincing evidence and preponderance of the evidence in a regular civil case, draw some analogies and take the facts in a particular case and show where they may establish a preponderance but certainly are not clear and convincing to prove fraud, particularly where the foundation has not been laid.

Funds Provided and Applied

There are a few documents which I would like to call to your attention and which are very important. I do not see how a taxpayer can be adequately represented in a hotly contested net worth case without a cash flow statement representing the funds provided for the purchase of assets and funds applied. As all accountants know, this is a statement of application of funds, sometimes called a statement of funds provided and applied, but I will just refer to it as a cash flow statement. When you receive the net worth statement from the Revenue Service, there is no discussion or no schedule which shows you how, for instance, stocks increased in value from year to year. If you will sit down with the taxpayer and get a complete history from him as to exactly what money he used to buy what assets and from what bank accounts (or other source) you will have a tremendous insight into specific taxable years and may well shoot a hole into at least a portion of the govern-

ment's case. Once the taxpayer has testified to this on the stand, then the CPA who has listened to the testimony or has received the reported testimony from the attorney, can prepare a statement. It is a simple matter to make changes in it during the course of the trial if necessary and show in a discussion on the stand in court how the increases and decreases occurred. If the court will not let this cash flow statement into evidence, then it is important nevertheless that the funds provided and funds applied information be either testified to, or stipulated to, so that a cash flow statement can be made up and inserted into the briefs filed before decision. It might be then possible to discredit many of the government's figures and cast an aura of suspicion on the entire net worth statement. Another procedure which you might find helpful where there are accumulated funds that were supposed to have either been in bank accounts or in cash on hand back many years ago, would be to have the taxpayer testify as to everything he earned and spent, going all the way back to the time that he started to accumulate funds. This may sound impossible, but if you will sit down and do it with the taxpayer, you can find out that he can quite frequently trace his *income and expenses* for a long period of time. You must be very patient and sit down for one or more uninteresting days to uncover the information and it is quite helpful to have the CPA present to take down these figures and to put them in proper schedule form. (On the subject of cash flow, see the November 1963 *Journal of Accountancy,* at page 65, *The Statement of Source & Application of Funds* (opinion No. 3—issued by the *Accounting Principles Board of the American Institute of C.P.A.s.)*

The taxpayer may say to you that he doesn't have tax returns going back to 1942 or 1940. The government may not have these on file either. Nevertheless, it may still be possible to get a certificate of assessments and payments. This can be obtained by ordering the same on Form 889 from the District Director of Internal Revenue. This form was revised in 1962. By taking the certificate of assessments and payments, quite frequently you can see how much taxes was paid, and how much estimated tax was paid. By determining the taxpayer's exemptions, and going back to the tax rates which were then in effect, you can reconstruct the taxpayer's gross income as reflected on his income tax return for earlier years, even though you do not have the return.

Taxpayer's Theory

From the taxpayer's point of view, the most important thing to remember is not to permit the resort to the net worth method if it is at all possible. If you can show where your client established his purchases, his cost of goods sold and kept his expenses properly and that all is missing is sales, why can't you reconstruct income on the basis of what

the sales were, perhaps with the predecessor company which was in the area, showing similarities? *Gounaris* v. *Comm.* (TC Memo 1963-145). Develop gross profits which might be applicable in a particuar business and show how the income reported is fair and is within reason. You may not be able to convince the court on the question of the actual deficiency involved. The court may say that you did not sustain the burden of proof and fail to rebut the net worth method itself. However, if your figures are within reason, and your taxpayer makes a nice appearance and apparently has acted in good faith, you may be able to knock out the fraud penalty which is the vicious sword which we all worry about in these cases.

Conclusion:

Blacks Law Dictionary Defines Fraud as:

> "A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated." (Citing *Johnson vs. McDonald,* 170 Okl. 117, 39 P.2d 150)

Remember, that is what the government must prove by clear and convincing evidence.

Your client may have been sloppy and negligent, but this is a far cry from the above definition.

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On the subject of fees:

1. Minimum fee schedule of the Norfolk Portsmouth Bar Association
2. *Tax Procedure for General Practitioners. The Practical Lawyer,* p. 20, Vol. 8, No. 3, March 1962.

Legal And Accounting Handbook of Federal Tax Fraud, Schmidt, Prentice Hall, Inc. 1963.

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Editor's Note—The foregoing paper by Mr. Knight reflects the remarks of one of the two discussants on a panel devoted to the subject entitled "The Preparation of a Civil Net Worth Fraud Case for Trial." The other discussant was Mr. W. Ralph Musgrove, Trial Attorney, Office of Regional Counsel, Internal Revenue Service. His remarks were presented informally, thus no formal paper is available for presentation herein.