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THE RECONSTRUCTION OF NET INCOME
UNDER § 446(b) OF THE INTERNAL
REVENUE CODE

JOHN J. HARRINGTON

The Internal Revenue Code of 1954 provides in § 446(b) that where

. . . no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as in the opinion of the Secretary or his delegate does clearly reflect income.¹

Possibly the most widely known of the methods employed by the Commissioner under the authority of this section is the net worth method.² However, there are several alternative methods and combinations of methods of reconstruction not uncommonly used by the Commissioner, including the excess cash expenditures method, the bank deposit method and the percentage markup method. This note will consider some of the principles and guidelines applicable to the use of these latter methods.

The excess cash expenditures method is derived from the better known net worth method. However, the cash expenditure method is concerned with the expenditures made by the taxpayer during the taxable year in question as an indication of his correct net income, while the net worth method infers income from the acquisition of assets. The logic of both methods is similar: Purchases by the taxpayer during an accounting period in excess of his declared income must represent undeclared income, after adjustment is made for non-taxable items, savings and other likely sources of capital for which the taxpayer can offer an explanation. The methods are in reality two sides of the same coin and the limitations placed on the use of the net worth method in the leading case of

¹ INT. REV. CODE of 1954, § 446(b).

² See Schwab, *The Civil Aspects of the Net Worth Method*, 3 WM. & MARY L. REV. 65 (1961).

*Holland v. U. S.*³ are equally applicable to the cash expenditure method, with one notable exception. Under both methods, according to the requirements of *Holland*,⁴ the government must overcome any non-taxable explanations offered by the taxpayer which would account for his purchasing power, if they are reasonably capable of being checked, as well as offering some positive suggestions as to a likely source of taxable income. The chief distinction between the two methods, insofar as the burden of the government's proof is concerned, is found in the computation of the opening net worth figure it is attempting to confer on the taxpayer. Under the net worth method, the government must establish a reliable opening net worth figure, but the Tax Court has held that a determination of opening net worth is unnecessary when using the expenditure method,⁵ at least where the taxpayer keeps no books or records. Although the court admitted that use of the expenditure method carried with it the implication that the taxpayer did not make expenditures from wealth accumulated prior to the period, it found that use of the method was not unreasonable on its face, where the taxpayer could not disprove the Commissioner's determination.

It is a logical consequence of the holding that no opening net worth figure is necessary under the expenditure method and an erroneous computation of that figure does not require court disapproval of the entire deficiency, and it has been so held⁶ in a case where the taxpayer's evidence as to the cash on hand was insufficient, it being based on uncorroborated testimony.

Specific court approval of the expenditure method in civil fraud cases was given in the *Mundy* case,⁷ while its application to the criminal fraud area was considered and approved by the Supreme Court in *United States v. Johnson*.⁸

³ 348 U.S. 121 (1954).

⁴ *Id.*

⁵ Joseph A. Mundy, 24 P-H Tax Ct. Mem. ¶ 55,270 (1955).

⁶ Homer L. Blackwell, 30 P-H Tax Ct. Mem. ¶ 61,124 (1961).

⁷ *Supra* note 5.

⁸ 319 U.S. 503 (1943).

The argument has been made that the Code does not give any authority in § 446(b) for the use of the expenditure method where the taxpayer has books and records from which income can be computed, but should be restricted to the situation where no adequate books and records exist. A similar argument was advanced in opposition to the net worth theory. However, two circuit courts are in agreement that the existence of books and records does not preclude application of the expenditure method any more than it forestalls the use of its parent, the net worth method. These courts have found that, similar to the net worth method, the expenditure approach is not a method of accounting, but evidence of unreported income which the Commissioner may resort to under § 446(b).⁹

Most of the litigation surrounding the use of the expenditure method, aside from challenges to the Commissioner's opening net worth figures, has centered about the adjustments which must be made to the computation for the estimated reasonable living expenses of the taxpayer, which are added to his proven expenditures and for non-taxable items which would help to explain a portion of his undeclared purchasing power. Again this is similar to the contentions normally advanced by the adversaries in outright net worth method cases, and there is no significant difference in the burden of proof and evidence under either method. The taxpayer will attempt to prove lower actual living expenses than that estimated by the government, the existence of non-taxable items overlooked in the Commissioner's determination, and double inclusions of the same income items by the Commissioner (a frequent problem where checks drawn by the taxpayer are not accurately matched against his living expenses or expenditures). As is the case under any reconstruction of income method, where estimates play such an important role, gaps of information will exist which must be clarified by the litigant who would be successful.

A more inexact method is the bank deposit method, which does not attempt to arrive at a net figure, as is the case with both the net worth and expenditure methods, but merely shows a discrepancy between actual and reported receipts. The

⁹ *Hoffman v. Commissioner*, 298 F.2d 784 (3rd Cir. 1962); *Goldberg v. Commissioner*, 239 F.2d 316 (5th Cir. 1956).

discrepancy may be due to entirely innocent causes and readily explained by the taxpayer. However, the increasing use by the government of this method, as with all the methods of income reconstruction, points the clear moral that supporting documents and papers of the taxpayer be retained at least for the period of the statute of limitations.

In common with the two methods previously mentioned, the bank deposit method assumes no tax exempt items of income or stores of cash from prior periods which would tend to explain the discrepancy. The theory behind the method is relatively simple and logical; the problems arise in connection with the characterization to be assigned to individual components of the formula. Taxable bank deposits are adjusted by adding items allegedly representing undeposited receipts of income, such as business receipts immediately expended either for the personal or business needs of the taxpayer. Frequently, the expenditures supposedly so made are estimates of what the taxpayer would reasonably have spent less that which is proven to have been spent. Unreported income is this total of expenditures and bank deposits less nontaxable items, mere transfers, redeposits and items taxable in a different year.¹⁰ The total taxable receipts as thus reconstructed by the Commissioner is then compared with the reported taxable receipts and the taxpayer who can offer no reasonable or convincing explanation for the discrepancy has a gloomy prospect.

It is obvious that more danger of injustice is inherent in this method than in the more frequently used net worth method and the courts have accordingly acted to confine it. Unlike the net worth and expenditure methods, the use of the bank deposit method is more apt to incur court disapproval where adequate books and records exist.¹¹ Although a court has stated that it will not prefer the use of the net worth method over the bank deposit method¹² and the Tax Court permits the use of the bank deposit method as evidence on the matter

¹⁰ 1 P-H 1963 Fed. Tax Serv. ¶ 6891.

¹¹ R. W. Jackson, 17 P-H Tax Ct. Mem. ¶ 48, 141 (1948); Harnsberger's, Inc., 7 B.T.A. 250 (1927); Edward Walsdorf, 4 B.T.A. 367 (1926).

¹² Miller v. Commissioner, 237 F.2d 830 (5th Cir. 1956).

of whether the books reflect a true picture of income,¹³ still the Commissioner may not act arbitrarily and illogically, as where the taxpayer is on an accrual basis. The bank deposit method in this situation would not be a proper criterion for determining income.¹⁴ It is especially to be noted in this connection that where the Commissioner can be shown to have acted arbitrarily, as where the Tax Court reduced by 85% the Commissioner's original determination of a deficiency,¹⁵ the burden of proof shifts from the taxpayer to the Commissioner, as the presumption in his favor is thereby lost.¹⁶ The taxpayer need not then prove the correct amounts.

As with the other methods of reconstructing income, gifts, loans and funds acquired in prior periods may be used to weaken the web woven by the bank deposit evidence. Thus, the known bank deposits will be reduced by the amount of loans the taxpayer can show to have been made or repaid to him.¹⁷

A fourth method employed in the reconstruction of income is the percentage mark-up method. The Commissioner determines an estimated profit margin which might reasonably be applied to the taxpayer's business. The percentage is then applied to some reliable book figure of the taxpayer's such as sales or cost of goods sold, or gross profit, in order to arrive at the reconstructed net income figure. The profit percentage to be applied is determined by the Commissioner on the basis of the taxpayer's own records in prior years, or similar taxpayers in an equivalent line of business. As with the bank deposit method, the Commissioner may not act arbitrarily in choosing his percentage,¹⁸ but neither is he required to use another method in place of it.¹⁹ However, the method will

¹³ James P. Haynes, 29 P-H Tax Ct. Mem. ¶ 60,221 (1960).

¹⁴ Sefer A. Markley, 17 P-H Tax Ct. Mem. ¶ 48,056 (1948).

¹⁵ *Cohen v. Commissioner*, 266 F.2d 5 (9th Cir. 1959).

¹⁶ *Thomas v. Commissioner*, 223 F.2d 83 (6th Cir. 1955).

¹⁷ *Grace O. Dean*, 24 P-H Tax Ct. Mem. ¶ 55,217 (1955).

¹⁸ *Fresbel Restaurant Corp.*, 23 P-H Tax Ct. Mem. ¶ 54,279 (1954).

¹⁹ *Bernstein v. Commissioner*, 267 F.2d 879 (5th Cir. 1959).

be rejected where the taxpayer's books and records are deemed to adequately reflect income.²⁰

The taxpayer can, in addition to attacking the rate used, show that it is not applicable to him, either because of a special situation, such as where his business methods were slipshod, so that he had a lower profit margin than the average similarly situated taxpayer,²¹ or excessive competition,²² or that in fact his business is not similar to the one from which the Commissioner determined the rate. The percentage mark-up method has been utilized primarily in those areas where it is customary not to keep adequate records, as is the case with gamblers and others in illegal lines of business, or as is the case with tips received by waiters and taxi drivers, those who frequently neglect to record income received in extremely small amounts.

Although these four methods of reconstructing taxable income are the ones most generally used by the Commissioner under the authority of §442(b), the present trend is away from reliance on a single theory in a particular case, in favor of the hybrid, or use of multiple theories.²³ This multiple approach where no one method would have been successful has been approved by at least one court.²⁴ Moreover, it has been suggested that theories which had their origin in criminal cases should now be applied to civil cases as well.²⁵ The importance of becoming conversant with these lesser-known theories of reconstruction of income, and their combinations, cannot therefore be stressed too highly for the tax practitioner and adviser who would serve his clients well.

²⁰ *Lunsford v. Commissioner*, 212 F.2d 878 (5th Cir. 1954); *Marvin T. Blackwell*, 25 P-H Tax Ct. Mem. ¶ 56,184 (1956).

²¹ *William Stratman*, 18 P-H Tax Ct. Mem. ¶ 49,143 (1949).

²² *Arthur Ward*, 17 P-H Tax Ct. Mem. ¶ 48,132 (1948).

²³ *Schmidt, Hybrid Methods of Reconstructing Income in Criminal Tax Fraud Cases*, 47 A.B.A.J. 560 (June, 1961).

²⁴ *United States v. Nunan*, 236 F.2d 576 (2d Cir. 1956).

²⁵ *Schwab, The Civil Aspects of the Net Worth Method*, 3 WM. & MARY L. REV. 65, 66 (1961); *Thomas v. Commissioner*, 223 F.2d 83 (6th Cir. 1955).