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The Civil Aspects of the Net Worth Method

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I.

Introduction

Although neither mentioned in the statute nor the regulations the net worth method looms of great importance in the field of federal income taxation. This disarmingly simple method of proving income by circumstantial evidence is based on the premise that income is reflected in the amount that net assets increase over a certain period. The basic formula simply states: Ending net worth minus beginning net worth plus non-deductible expenditures equals taxable income if the taxpayer was not the recipient of any non-taxable income.

This method of income determination has its genesis in cases concerning prosecution of such nefarious persons as gangsters and racketeers. The origin of the use of this method traces back to the prosecution of one of Al Capone’s brothers in 1931. With mounting use being made of this method subsequent to the Ke-fauver Committee investigation of this group of “should-be-
taxpayers," concern generated by the Bar caused the Supreme Court in 1954 to grant certiorari in four net worth cases.6

The Court approved the use of the net worth method after taking cognizance that certain dangers exist which must be guarded against. These four landmark cases shattered what hopes remained that the circumstantial inferences of taxable income deduced from the net worth method were too dangerous for use in convicting a person.7

Theoretically there is no reason why the net worth method is applicable only to criminal law. Certainly if the method is safe enough to use in criminal prosecutions, its use can be employed in civil suits. Even before the Supreme Court's approval, the net worth method was used extensively in the examination of all types of returns.8 Not only can the method be used in civil suits, but there is no reason why it should be restricted to cases of income derived from an illegal business.9

Much has been written concerning the use of the net worth method, though, the emphasis has been on its use in criminal cases. Since historically speaking the Supreme Court's approval is of recent origin, the scope of this paper is confined to an inquiry into the civil aspects of applying the net worth method. The reason for thus confining the topic is that it may well be that with maturity the method may become of even more importance in civil cases. Because of differences in the required burden of proof placed on the government, cases arise where the emphasis is not on a threatened criminal prosecution and subsequent civil suit, but merely on the civil aspects of the case.

The dangers to be guarded against are just as real and bothersome in a civil suit as in a criminal case, in fact more so because

5Blackburn, Arbitrary Methods of Income Determination, 30 TAXES 905 (1952).
7Mitchell, The Net Worth Doctrine, 14TH ANNUAL INSTITUTE ON FEDERAL TAXATION 1345 at 1356 (1956).
8Blackburn, supra note 5.
the government's burden of proof is less.\textsuperscript{10} Since this is true, there is sound reason for focusing an inquiry on the civil aspects of the use of the net worth method.

Instances where only the civil aspects are of importance result from the fact that the statute of limitations for criminal prosecutions is 6 years\textsuperscript{11} whereas there is no limitation for recovery of a tax deficiency if fraud is present.\textsuperscript{12} In such cases the only tool which the government has in its arsenal is the civil suit.

Another reason why the civil aspects of the net worth method could become more important would be if the civil penalties for fraud were the only sanction for fraud. The imminent future will not abolish the criminal sanctions, but we may be in the embryonic stage where society feels that tax evasion is not the type of "crime" justifying criminal sanctions,\textsuperscript{13} that civil penalties alone may be sufficient.\textsuperscript{14}

The Commissioner of Internal Revenue's annual report for fiscal year 1955 states that fraud investigations received vigorous impetus from the broad approval given by the Supreme Court of the net worth method of proving income. The annual reports prior to 1955 list the number of civil fraud penalty recommendations. However, since 1955 this information is merged in a broader category.

The 1958 annual report states that the Internal Revenue Service policy is to emphasize better geographical coverage and selection of cases for their deterrent value.

\textsuperscript{10}Balter, Bar Group Proposes 8-year Statute on Civil Fraud, 9 J. TAXATION 116 (1958).

\textsuperscript{11}Int. Rev. Code of 1954, § 6531.

\textsuperscript{12}Int. Rev. Code of 1954, § 6501.

\textsuperscript{13}See Lyon, The Crime of Income Tax Fraud: Its Present Status and Function, 53 COL. L. REV. 476 (1953). The author states that the prevailing view dictates that criminal penalties are necessary and merely assumes that such conclusion is true.

\textsuperscript{14}To a certain extent this attitude is expressed in the recent American Bar Association proposal that the Code itself contain a grant of immunity from criminal prosecution for a tax fraud voluntarily disclosed. Balter, Immunity for Voluntary Disclosure Should Be in Code, 13 J. TAXATION 252 (1960).
Although the statistics do not warrant an inference of the increased use of the net worth method, the expansion of the enforcement staff planned for 1961 to broaden the scope of the enforcement program is cause to wonder if an increased use of the method will be employed in determining income.\(^\text{15}\)

Although it is difficult to prognosticate concerning the extent that the net worth method will be used in the future, for practical purposes it is sufficient to state that it is well recognized and, by court litigation, is now a legitimate tool which is used extensively by the Internal Revenue Service in both civil and criminal cases.

II.

*Civil Fraud*

The net worth method is a method of determining income and since virtually every civil case involves the ultimate question of whether there is a deficiency, the net worth method theoretically has wide application. The net worth method has usually been employed where the government hopes to prove fraud; however, failing to prove this, the same computations can be used to prove a mere deficiency.

Civil fraud can be simply defined as the filing of a false or fraudulent return with the intent to evade taxes. Simplicity of definition is required, otherwise were the statute to enumerate in detail, the statute would encourage a multiplicity of means by which taxpayers could *avoid* the fraud penalty and *evade* the spirit of the law.\(^\text{16}\)

Since the proscribed element is intent the net worth method is especially applicable to fraud cases. Knowledge of the presence of this subjective element is peculiarly within the province of the taxpayer and under the circumstances his testimony on this point can be given little credence.\(^\text{17}\) Therefore, the ultimate issue must

\(^{15}\text{ANNUAL REPORT, Commissioner of Internal Revenue 94 (1960).}\)

\(^{16}\text{Spencer, Proof of Income Tax Fraud, 2 TAX L. REV. 451 (1947).}\)

\(^{17}\text{Albert Axler, P-H T.C. Memo. ¶ 56,058 (1958).}\)
be proved by circumstantial evidence.\textsuperscript{18} The net worth method affords such a means.

The net worth method is of special help in determining taxable income where no return has been filed or where significant items of income have not been reported. The method is rarely employed in regards to excessive deductions as these are shown on the face of the return and can usually be detected by normal office audits.

If fraud is established the 50 percent fraud penalty is applicable.\textsuperscript{19} The 50 percent penalty is applicable against the entire amount of the deficiency or underpayment although only a part of the deficiency is due to fraud.\textsuperscript{20} "Underpayment" is defined by the statute to take into account the amount of tax shown on the return only if such return was timely filed.\textsuperscript{21} Thus, if a return is not filed on time the fraud penalty is 50 percent of the amount of the tax. If the fraud penalty is imposed the delinquency penalty,\textsuperscript{22} the 5 percent negligence penalty\textsuperscript{23} and the 100 percent penalty\textsuperscript{24} for failure to collect and pay over the tax are not imposed.\textsuperscript{25} The taxpayer finds that his discovered fraud is expensive especially when one considers that in addition to the payment of the sum of the deficiency and fraud penalty, he is also liable for interest on the amount of the underpayment or non-payment at the rate of 6 percent per year from the last date prescribed for the payment to the date paid.\textsuperscript{26}

\textsuperscript{18}Spencer, \textit{supra} note 16.

\textsuperscript{19}Int. Rev. Code of 1954, § 6653(b).

\textsuperscript{20}\textit{Ibid}.

\textsuperscript{21}Int. Rev. Code of 1954, § 6653(c).

\textsuperscript{22}The amount of this penalty is 5 percent of the amount of such tax if the failure is not for more than 1 month, with an additional 5 percent for each additional month or fraction thereof. The maximum penalty, however, shall not exceed 25 percent in the aggregate. Int. Rev. Code of 1954, § 6651(a).

\textsuperscript{23}The addition to the tax is 5 percent of the underpayment. Int. Rev. Code of 1954, § 6653(a).

\textsuperscript{24}The base upon which the 100 percent penalty is imposed is the amount of the tax evaded, or not collected, or not accounted for and paid over. Int. Rev. Code of 1954, § 6672.

\textsuperscript{25}Int. Rev. Code of 1954, § 6653(d).

\textsuperscript{26}Int. Rev. Code of 1954, § 6601.
Although the sanctions imposed for fraud appear severe, the justification advanced for such additions to the tax is that they are necessary to compensate the government for what is normally a more costly investigation and if the person perpetrating the fraud did not bear a substantial portion of this cost, the honest taxpayers would be required to subsidize these enforcement activities to a greater extent.27

The Code provides that 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 is on the Commissioner.28 This requirement is in Subchapter C of Chapter 76, subtitle F, which deals with the Tax Court. The government has contended that this section is not applicable where a taxpayer sues in a district court for a refund of taxes previously paid. The government contends that in the district court the taxpayer must establish his freedom from fraud. However, the courts have held the burden is on the government regardless whether the Tax Court or a district court has jurisdiction29 since the code section is only declaratory of what had theretofore been the law in both courts.30

The government is required to show civil fraud not merely by a preponderance of the evidence, but by clear and convincing evidence.31 A showing of a large understatement of income does not establish fraud even though the understatement has occurred for consecutive years. Of course, such may be very relevant, but fraud is never imputed or presumed and thus cannot be predicated merely on an omission of income.32

27Lyon, supra note 13.
32Ibid.
III.

Cases Other Than Fraud

Although the net worth method is usually employed where fraud is suspected, there is nothing prohibiting the application of the method merely to prove a deficiency. Because of the relatively high cost of a net worth case a mere deficiency case would not warrant its use. The higher the deficiency the more susceptible is the case for fraud; the lower the deficiency the more probable it is that a true income determination can be obtained by adjusting the taxpayer's books and records.

It is more conceivable that a deliberate attempt would be made to employ the net worth method if the Commissioner, having no grounds to suspect fraud, feels that a considerable amount of income has been unreported due to negligence. Were the negligence in the failure to keep adequate books and records, the net worth method could circumstantially show the amount of income. Under such a case the Commissioner would be justified in imposing the 5 percent negligence addition to the amount of deficiency determined.

Generally speaking the Commissioner must assess the amount of any tax deficiency within 3 years after the return is filed. A considered investigation involving underreporting of income resulting from negligence, however, will likely come within the 6 year statute of limitation. Where a taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in his return the tax may be assessed at any time within 6 years from the time the return was filed.\[35\]

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\[35\] The 6 year statute of limitations does not apply if no return was filed (even if due to negligence) or if fraud is involved. Section 6501(e)(1)(ii) provides that in determining the amount omitted from gross income, account is not taken of an amount omitted if the return is accompanied by a statement disclosing the amount omitted in a manner sufficient to apprise the district director of the nature of such item. The obvious purpose of this is to encourage the taxpayer to apprise the director of "dubious" gross income exclusions.
Theoretically negligence penalty cases appear quite susceptible to the use of the net worth method and the 5 percent penalty has been imposed where the net worth method disclosed a deficiency.\(^{36}\) However, it is rare to find these instances of the use of the net worth method.

Perhaps the reason for this is that the Internal Revenue Service under its discernible selectivity policy has viewed prospective negligence penalty cases as lacking substance and more specially revenue potential, especially considering the necessary expense incurred in the development of the net worth computations.

Thus, it is seen that in the area of civil cases the net worth method is employed primarily in the fraud cases. However, there are numerous instances where the net worth method has been held to prove merely a deficiency where the Commissioner did not prove fraud. Fraud must be proved clearly and convincingly; however, there is a statutory presumption of the correctness of the Commissioner's determination of a deficiency. Thus there is a "no-man's land" where neither party has carried its burden of proof and therefore the deficiency is assessable and the fraud penalty is not applicable.

The penalties for both fraud and negligence cannot be applied to the same deficiency.\(^{37}\) Thus, if fraud is found the greater penalty applies. The negligence penalty will not be imposed unless the Commissioner has pleaded it.\(^{38}\)

There are a number of cases where the Commissioner has not been successful in proving fraud and thus the taxpayer pays merely the deficiency. In regard to these cases the question arises as to the possibility of the assertion of the negligence penalty. Negligence is not the necessary alternative to the conclusion of no fraud,\(^{39}\) however, it would appear that if the Commissioner did not bear the burden of proving fraud the evidence submitted

might show negligence. In the case of *Louis Wald* the Board granted the motion to reduce the charge from the 50% to the 5% penalty. The courts will not change a fraud penalty to a negligence penalty because fraud is not proved inasmuch as the conclusion of no fraud may be no fault whatever, not even negligence. However, even where the evidence does not sustain fraud but is sufficient to show negligence the court won't impose the negligence penalty on its own initiative as this is an administrative function.41

Rule 17 of the Rules of Practice Before the Tax Court provides that the Court may at any time during the course of the trial grant a motion of either party to amend its pleadings to conform to the proof. It would be unusual to expect the Commissioner to amend his answer to assert negligence instead of fraud as in the *Louis Wald* case, *supra*, inasmuch as the government would hope that it had introduced sufficient evidence to show fraud. Thus, if the court finds no fraud the taxpayer is then obliged to pay only the deficiency, if a deficiency has been found. It is in this area that it appears that the government is losing considerable revenue by not pleading negligence in the alternative were the court to find that fraud had not been clearly and convincingly established.

There is a paucity of cases where the government has pleaded negligence in the alternative to the fraud penalty. The following will indicate that this has not always been successful.

The holding in the *James Nicholson* case was:

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408 B.T.A. 1002 (1927).

Since the principal followed by the courts is that they won't impose a penalty unless same has been pleaded, it is difficult to reconcile the case of *L. A. Meraux*, 38 B.T.A. 200 (1938), wherein the government by amended answer asked that in lieu of the 5 percent negligence penalty the 50 percent fraud penalty be imposed. Such a motion might be denied by the court as being prejudicial to the taxpayer as at this time of the trial he might be unable to defend this greater charge. However, the converse would not appear to be prejudicial. The court found no fraud but imposed the negligence penalty. By the amended answer the negligence penalty had been deleted, thus, in effect, the court imposed the penalty for negligence when in fact it was no longer in the pleadings.
Where respondent did not determine a negligence penalty or plead negligence affirmatively in his answer, except that he requested therein the imposition of a negligence penalty if the Board should find the taxpayer not guilty of fraud, and where no evidence is adduced on the subject of negligence, no negligence penalty may be imposed.42

In a subsequent case43 the Commissioner in his answer alleged fraud, or in the alternative, negligence. The court held that when the fraud allegation was withdrawn the claim for negligence fell also. "It was not pleaded as an absolute proposition on its merits and the evidence was not directed at the substantive question of whether the deficiency was due to negligence. In this state of the record it is fair to say that the subsidiary claim for negligence fell with the withdrawal of the claim for fraud."44

There is nothing contained in the Tax Court Rules of Practice to prevent alternative pleading. In the case of Lucian T. Wilcox45 the Commissioner was successful in pleading in the alternative. The court held that the government did not show any part of the deficiency was due to fraud; but, further held that the government had shown negligence and under an alternative allegation contained in the answer, the negligence penalty was imposed.

The above cited cases were not net worth cases. A review of the net worth cases shows an absence of alternative pleading. It is submitted that the reluctance of the Commissioner to use alternative pleading in such cases stems from an inclination that such pleading would psychologically weaken the case. This thought is entitled to special weight in net worth cases as the deficiency is shown by circumstantial evidence. Since there is usually no direct proof in net worth cases of fraudulent intent the court may be more willing to find negligence rather than fraud if given the alternative as in the Wilcox case, supra.

If the above speculation is entitled to any weight then the problem of loss of revenue is vitiated, that is, the present policy of

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4232 B.T.A. 977 (1935).
44Ibid.
4544 B.T.A. 373 (1941).
not pleading in the alternative is consistent with the concept of a revenue maximizing enforcement policy of all revenue that is justly owing the public fisc. On behalf of the taxpayer the approach is not inequitable as the fraud issue is the Commissioner's burden and if such isn't shown by the necessary quantum of proof the taxpayer merely pays the deficiency.

IV.

Application of the Net Worth Method to Civil Cases

The remainder of this paper is devoted to the application of the net worth method of proving civil fraud or a deficiency once the case reaches the trial stage.

Code section 446 provides the methods of accounting that may be employed and further provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. This general rule is subject to the statutory exception that if no method of accounting has been regularly used, or if the method does not clearly reflect income, taxable income shall be computed under such method as does clearly reflect income.

At one time there was support for the position that a prerequisite for the use of the net worth method was a showing that the books were inadequate. This would severely limit the use of the net worth method, as one can easily imagine a set of books internally consistent but not correctly reflecting income because of the omission of certain receipts. Thus to prove the books inadequate it would be necessary to offer direct evidence of the omission and such direct evidence would be virtually impossible to obtain in many cases. In such a case the direct evidence relating to the omission could possibly be sufficient to support a finding of fraud, but under the facts of the case, without resort to a net worth computation, there would be no manner in which to determine the amount of the deficiency and consequently the amount of the ad valorem fraud penalty.

The increase in the taxpayer's net worth is of itself strong evidence that the books are unreliable and warrants the govern-

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46Burns, How to Defend a Net Worth Case, 32 TAXES 537 (1954).
ment using the net worth method in computing taxable income.\textsuperscript{47}

The Supreme Court has said that the government is not required to prove that the taxpayer's books were inadequate or false in order to use the net worth method of reconstructing income. In reaching this conclusion in the \textit{Holland} case\textsuperscript{48} the Court said: "Certainly Congress never intended to make section 41\textsuperscript{49} a set of blinders which prevents the Government from looking beyond the self-serving declarations in a taxpayer's books ... To protect the revenue from those who do not render true accounts; the Government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflect his financial history."

The prevailing view concerning the procedural defense of adequate records is expressed as follows:\textsuperscript{50}

Although the \textit{Holland} case was a criminal case, there is no reason why the analysis therein should not apply with equal force to a civil case or why the use of the net worth method should be more circumscribed in the case of a deficiency determination. The fact that the taxpayer's books and other records are consistent with his income tax returns or are internally consistent proves nothing more than that they are consistent; it does not establish that they are truthful or accurate. The \textit{Holland} decision makes it clear that there are no conditions precedent to the utilization of the net worth technique.

Although it is not necessary for the government to first prove the inadequacy of the taxpayer's books this is not to imply that the adequacy and accuracy of the taxpayer's books is not an important question in the trial stage of a net worth case.\textsuperscript{51} The courts have at several times used language indicating that if the taxpayer's books and records are proved to be adequate the government is not entitled to resort to a net worth computation in

\textsuperscript{47}Delores L. Ambrose, P-H T.C. Memo. ¶ 60,232 (1960).
\textsuperscript{48}Holland v. U.S., \textit{supra} note 6.
\textsuperscript{49}1939 Code; Int. Rev. Code of 1954, § 446.
\textsuperscript{50}Davis v. C.I.R., 239 F. 2d 187 (C.C.A. 9th 1956); \textit{cert. den.}, 353 U.S. 984.
\textsuperscript{51}Avakian, \textit{Current Developments in Net Worth of Establishing Fraud}, 1957 MAJOR TAX PLANNING 605.
reconstructing taxable income. These utterances are broader than need be. It would be most difficult for a taxpayer to prove that he did not omit to record any cash transactions, as this tantamount to proving a negative. Often, because of the nature of tax evasion, the government is unable to establish the omission of income items by direct evidence. Such failure, however, cannot be tantamount to a conclusion that the books are adequate and accurate. The corollary that necessarily follows is that where the taxpayer endeavors to prove that all income items have been recorded, such is not conclusive of the adequacy of the records.

The conclusions reached by the courts in the cited cases are correct; however, a better statement of the rule would be that just because the government has employed the net worth method does not require those charged with the final determination of the facts to also employ it, the judicial branch may conclude that the taxpayer’s books more correctly reflect the taxable income. This conclusion is a simultaneous determination that the proof shows the taxpayer’s books to be more accurate than the net worth method. The net worth computations should total to the same taxable income, if they don’t, the court may find that the net worth computations are not as reliable as the taxpayer’s records or adjustments based on specific items.

1.

The Net Worth Formula

"Increase in net worth plus non-deductible disbursements minus non-taxable receipts equals taxable net income." The first steps involved in the application of this formula is the computation of the taxpayer’s net worth at a fixed starting point and also an ascertainment of his net worth at the close of the period under consideration. The beginning net worth is of vital importance inasmuch as the usual defense is the taxpayer had a cash hoard which is not included in the government’s opening net worth.


The theory underlying the net worth method is that if the net worth increase as shown by the difference between the beginning net worth and the ending net worth is greater than the income reported, the taxpayer has understated his income. Likewise, if there is no increase in net worth but if the taxpayer has expended larger amounts than his reported income on non-deductible items, there has been an understatement of income.\textsuperscript{55}

Therefore, certain adjustments must be made to the difference between the beginning and ending net worth. Adjustments necessitated include the following:

1. The amount of non-deductible expenditures for personal and living expenses must be added. Here caution must be made to avoid a double inclusion in the amount of taxable income. If personal capital expenditures such as automobiles, homes, and the like, were made, such will not be added to the difference between beginning and ending net worth if they have been reflected as assets included in the ending net worth.\textsuperscript{56} Under this adjustment the amount of Federal income tax payments would be added to the increase in net worth.

2. Nontaxable receipts must be deducted. This includes gifts, bequests and other receipts exempt from tax. These must be deducted because such receipts have either been spent on assets includible in ending net worth or the receipts were expended in another form in which case they would be added under adjustment No. 1.\textsuperscript{57} An alternative procedure would be to completely ignore gifts and inheritances, that is, neither include it in the ending net worth nor allow a deduction for same. Regardless of which procedure is employed the same result will obtain.\textsuperscript{58}

3. An adjustment must be made excluding that portion of profit resulting from capital gains to the extent that such profit is not taxable under the capital gains provisions of the code.

4. In the case of property which is used in a trade or business

\textsuperscript{55} P-H 1961 FED. TAX SERV. ¶ 6059.


\textsuperscript{57}Ibid.

\textsuperscript{58}Avakian, \textit{The Net Worth Method of Establishing Fraud}, 11TH ANNUAL INSTITUTE ON FEDERAL TAXATION 707 at 708 (1952).
or held for the production of income and which is depreciable under section 167 certain adjustments must be made. If the asset were listed at its cost value the difference between beginning net worth and ending net worth would be ceteris paribus, overstated by the amount allowable as depreciation expense in computing the taxable income. There are three alternative ways in which depreciable property may be handled.59

(a) The depreciation can be ignored in computing net worth in which case the allowable depreciation will be subtracted from the net worth increase in the same manner as the previous adjustment made to the difference between beginning and ending net worth.

The remaining two alternatives make adjustment for depreciation before arriving at the difference between beginning and ending net worth.

(b) The depreciable property can be listed at full cost in the beginning net worth computations and then offset by the allowable amount of depreciation which is listed as a depreciation reserve under the liabilities section.

(c) The remaining alternative is to list the asset each year at a figure which represents the adjusted tax basis at that time. This means that the asset should be listed in the beginning inventory computations at that figure which accountants call its "book value." Likewise if the asset is in the ending net worth computations it would be listed at its cost minus the amount of allowable depreciation to date.

Although all three procedures arrive at the same final result, the Fifth Circuit Court of Appeals this year said, "In using the net worth method, the value of opening assets is their current value, not their original cost."60 This statement by itself is misleading inasmuch as the net worth method, notwithstanding the implications of its name, is not a measure of the taxpayer's net worth but a method of reconstructing income. In reconstructing such income the pertinent figure is not the fair market value but the cost basis adjusted for allowable depreciation. As a procedural point the net worth computations made by the government have

59Ibid.

60Cefalu v. Commr., supra note 3.
been based on the third approach. In *Murl P. Clark*\(^{61}\) the reserve for depreciation is treated as a deduction for the assets in arriving at net assets. The effect of this is to include the asset in the beginning net worth computations (or ending net worth computations) at its "current value" for tax purposes.

The accounting elements going into the net worth computations are worthy of competent considerations. However, the real issues are the inferences which the government makes in regards to an increase in net worth.

The Commissioner has not confined the net worth method just to a single taxpayer. The case of *William G. Lias*\(^{62}\) broadened what was previously the use of the net worth method by employing a consolidated family net worth technique. The combined taxable income of the taxpayer, his wife, his brother, and brother-in-laws, was determined by taking the increase in their combined net worth, making the necessary adjustments, and then from the combined taxable income deducting the income reported by those members of the clan other than the taxpayer. The resultant is the taxable income of the taxpayer. The Commissioner's computations were upheld in court, and on appeal the Tax Court was affirmed.

In the case of *Charles A. Polizzi*\(^{63}\) the combined net worth approach was again used. From the combined gross income derived, the wife's gross income (as shown by her tax returns) was deducted in order to arrive at the gross income of the taxpayer. As in the *Lias* case, *supra*, the fraud penalty was also imposed. In 1958 the Tax Court again had occasion to uphold a combined net worth approach between taxpayer and his wife, the only difference being that from the combined net worth increase nothing was deducted as the wife's income inasmuch as she reportedly had no income.\(^ {64}\)

There is a paucity of cases dealing with the combined net worth approach and if this approach is used to a greater extent

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\(^{61}\)P-H T.C. Memo. ¶ 56,176 (1956).


\(^{63}\)P-H T.C. Memo. ¶ 57,159 (1957).

\(^{64}\)Richard F. Smith, 31 T.C. 1 (1958).
there are bound to be safeguards erected. It will be noted in the Lias case that from the combined increase in net worth was deducted the income reported by those other than the taxpayer. In effect this means that fraud, which must be clearly and convincingly shown, uses a deficiency determination based on the admissions of those other than the taxpayer. There are undoubtedly situations where the combined net worth approach can and properly should be admissible, but it would seem that if the Commissioner were to rely on the income as reported by one other than the taxpayer, he should be required to prove such reported income is accurate or proffer evidence from which the court could conclude that such third person could not have earned more than what was shown on his return. Or in the absence of such proof, some action on the part of the taxpayer which indicates the correctness of such other person's reported income should be necessary. The Richard F. Smith case, supra, wherein the taxpayer by listing his wife as an exemption for the pertinent years justified the conclusion that the wife had no income in those years, illustrates how taxpayer's own action verifies income of third party.

The Commissioner has not been able to use the combined net worth approach unabated. In rejecting such an approach, even though the parties upon whom the net worth computations were made were spouses, the court said:65

While we can sympathize with respondent's dilemma in determining to whom the unreported income should be attributed, we nevertheless cannot condone his solution to the problem. The net worth theory is fraught with enough dangers without adding another. Thus, the mere fact that Settino reported X amount of income in his separate income tax return for 1948 is no guarantee that the remaining amount of unreported income is attributable to petitioner. In order for such a syllogism to equate itself it is necessary to assume that Settino's return was correct. We cannot indulge this assumption and consequently respondent's computation of petitioner's income based thereon must be rejected.

Unfortunately in this recent enunciation the Tax Court neither uses citations nor does it refer to the Lias case. Equally

65Theresa Accardi, P-H T.C. Memo. ¶ 58,090 (1958).
unfortunate is the fact that it is a Tax Court memorandum case and the Commissioner neither acquiesces or non-acquiesces in such cases so there is no indication as to what the attitude of the department is concerning the continued use of the combined net worth approach.

2.

The Starting Point

The Government’s first task in a net worth case is to establish the opening net worth with reasonable certainty.\(^6\) Despite the essential difference between burden of proof in a criminal and that of a civil case, it has been held that the determination of the opening net worth should not be any less vital to the validity of the method of computation invoked in one type of case than in the other.\(^7\)

An increase in net worth from which taxable income is inferred is predicated upon the difference between beginning and ending net worth. An ascertainment of beginning net worth is essential to prove that there has in fact been an increase in net worth or to negate an assertion that the expenditures made during the period were financed out of funds previously accumulated, rather than the receipt of unreported taxable income.\(^8\)

The year selected for the beginning net worth is not necessarily the year or first year for which a fraud penalty is being asserted. The beginning net worth is merely the reference point from which the computations are made. Thus, the beginning net worth must be adjusted to render the net worth at the beginning of the first year under question. This is done by taking the starting point and bringing it up to the year in question by adding the income reported on the taxpayer’s returns for the intervening years from the starting point to the first year in question. Unlike the taxpayer’s returns for the years in question, it is assumed that the taxpayer’s returns for these intervening years are correct. If this assumption is not true the theoretical result is that where

\(^{6}\)Avakian, \textit{supra} note 51.

\(^{7}\)Thomas \textit{v.} Commr., 223 F. 2d 83 (C.C.A. 6th 1955).

these returns involve an understatement of income such income becomes taxable income in the period under consideration. Little objection may be offered to such a glib use of the taxpayer's returns on the grounds that if income is unreported it should not escape taxation. However, the results of such misallocation has its effect on the effective tax rate which is applicable, and also on the amount of the ad valorem penalty. In the case of fraud, there is no statute of limitations, and the Commissioner would not be barred from collecting the deficiency regardless in which year the understatement occurred. The only effect then of such a misallocation would be on the effective tax rate, thus, if there is a large understatement of income of a prior period placed in one or several taxable years under consideration, the taxable income would be subject to a greater surtax.

Proof of the beginning net worth sometimes is not too difficult because of the cooperation of the taxpayer. There is no problem where the net worth statement has been prepared by the taxpayer and accepted by the government or where the statement was jointly prepared by the taxpayer and the government.69

The prior tax returns of the taxpayer may be helpful in disclosing acquisition date and cost of property which are relevant in determining beginning capital. Likewise, the dividend schedule of the return may list securities owned and the interest section will give clues as to what banks should be checked for bank accounts.70

The government is especially interested in financial statements which the taxpayer has furnished creditors inasmuch as these statements are often required as a prerequisite for obtaining credit. Under such circumstances the taxpayer usually desires to present the best picture he can, thus these statements are likely to have a high probative value in establishing opening net worth when used by the government as the higher the beginning net worth the less the increase. Likewise, the probative value is low if used by the government to establish the ending net worth inasmuch as, where motivated by the same desire to paint a bright

69Gordon, The Use of Net Worth as a Basis for Civil Liability, 11TH ANNUAL INSTITUTE ON FEDERAL TAXATION 799 (1952)

70Avakian, supra note 51.
picture, such results in an overstatement in the net worth increase.\textsuperscript{71}

These financial statements are relevant, not conclusive, in computing the beginning net worth. Such admissions can be rebutted. This can be done in the case of statements furnished to prospective creditors. The presumption that the taxpayer is desirous of painting a bright picture would be inapplicable where the taxpayer did not desire to disclose the extent of his wealth to a third person and where such an understatement of assets would not adversely affect him.\textsuperscript{72}

In \textit{Etta H. Harvey}\textsuperscript{73} the Tax Court concluded that the beginning net worth was larger than shown in the net worth computations presented by the government. These computations used the taxpayer's net worth statement which he had previously submitted to the government regarding a tax deficiency for a prior year. The court said, "Only if ... petitioner knew the purpose of the net worth statement and gave (the revenue agent) full information as to all her assets, is there any significant proof negativing petitioner's evidence as to possession of a larger amount at that time." With the lack of additional evidence showing how the taxpayer could have earned such considerable income as shown by the government's figures, the court was willing to accept the taxpayer's explanation of listing only sufficient assets in her net worth statement which would show the government that she was capable of paying the deficiency.

Little difficulty is encountered in establishing a starting point if the taxpayer recently went through bankruptcy. Another instance where the government reverts to a zero beginning net worth is where the taxpayer commenced his business or profession after finishing school.\textsuperscript{7} Often it is not difficult to prove that at the time he finished his school he had debts and entered his business or profession on borrowed capital or through the patronage of some sponsor. That is to say, evidence is often available as to the financial condition of the now-wealthy doctor when he came to town a decade ago as the "new young doctor."

\textsuperscript{71}Gordon, \textit{supra} note 69.

\textsuperscript{72}Gordon, \textit{supra} note 69.

\textsuperscript{73}P-H T.C. Memo. ¶ 54,219 (1954).
The most troublesome problem in a net worth case is establishing the starting point when the evidence contains no admissions on the part of the taxpayer. In such a case a full scale investigation must be conducted.

As previously mentioned the usual defense in these net worth cases is the existence of a cash hoard which has not been taken into consideration in the government's beginning net worth computations. Of course, a larger beginning net worth would diminish or eliminate the amount of increase found between the beginning and ending net worth. It is to this interesting problem of the cash cache that attention is now directed.

"Of course, some people still keep cash hoards—or so they say in tax cases when it is to their benefit to have a large opening net worth." Although one may wonder why a person would leave money lying around idle earning no interest, especially since the long run economic history of this nation shows inflation, the fact remains that money has been found hidden in mattresses and the like even though the owner has been living with frugality and sometimes to the extent of malnutrition of his body. The hiding of money is a secretive act and the man who buries his wealth does not share knowledge of its hiding place with many people. Because of this very nature of the secretive act, the taxpayer has a difficult time proving this defense.

The taxpayer often has very little evidence to prove the existence of the cash hoard other than his own testimony. Such testimony might be described as "incredible," "improbable" or "self-serving" but it does not have to be disregarded by the court. "We know of no such rule of evidence. Certainly, the taxpayer is entitled to tell his story and if the story brings conviction in the mind of the Court that it is the truth, he is entitled to prevail."

In order to appreciate the few cases in which this defense has been successfully employed it is necessary to understand how the government negatives the existence of a cash hoard. The

74 Cefalu v. Commr., supra note 3.
75 Neely, Cash Hoards, 6 J. TAXATION 228 (1957).
76 V. H. Jorgensen, P-H T.C. Memo. ¶ 56,113 (1956).
existence of a cash hoard is a fact question and the government relies on an accumulation of circumstances to negate the existence of such a hoard. The following circumstances are relevant in negating the existence of the hoard, although, no one fact may be determinative in a given case and the various circumstances may carry more or less weight when applied to a particular case.

Where the defense asserts that the cash originated from a gift the government's task is to show that no such gift occurred. Seldom will the government be able to show the lack of a gift by direct proof as the donor is usually deceased. The procedure used to show the absence of the gift is to show the alleged donor did not have the means of making such a gift. Thus in one case the conclusion was reached that no gift of $33,865 was made where the alleged donor never filed a Federal or state income tax return, had $10,000 at death, the husband worked as a laborer, there was no evidence that the donor ever made any investments which resulted in large gains thus negating the possibility of any capital appreciation of original savings, and where donor was supporting a family of five during the years in which the alleged gift was purportedly made.  

Where the taxpayer claimed a $20,000 gift from his father in 1931 economic conditions of the time were helpful in showing the inability of the father to make such a gift. The father had gone through bankruptcy in 1929 and the court concluded that between the date of the father's discharge in bankruptcy and the date of the alleged gift, business conditions were not favorable for the rapid accumulation of money.

Where the allegation is that the hoard originated out of the taxpayer's own frugality, the taxpayer's own financial history is used to show that such accumulation could not have been possible from his income record as indicated by his returns. Also

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77W. W. Kane, P-H T.C. Memo. ¶ 59,111 (1959).
79In W. L. Drake, P-H T.C. Memo. ¶ 52,319 (1952), the government contended that the taxpayer's returns for the years prior to those in question did not report sufficient taxable income to account for the taxpayer's alleged beginning net worth. The court indicated that it was concerned only with the years in question and that there was nothing in the record from which it could determine whether the prior tax returns were correct or incorrect.
it is hard to reconcile an existence of substantial cash when the taxpayer has borrowed money at substantial interest rates, rendered financial statements omitting such cash hoard, or allowed insurance policies to lapse for non-payment after having borrowed the maximum loan value on them.

The taxpayer's task would be especially onerous if after informal conferences the taxpayer takes the stand and for the first time mentions a large cash accumulation. Such a defense will obviously be subject to the attack that it is but a recent fabrication.

If the justification for the cash accumulation is a distrust in banks the taxpayer finds it awkward to explain the existence of various bank accounts.

Coupled with other evidence the court has held it difficult of belief that a "man of plaintiff's education and business ability would pile up such a huge sum in a sideboard drawer."

Finally, the court may conclude that the testimony of the taxpayer and other witnesses are unworthy of belief and that such "obvious fabrication would challenge the talents of Edgar Allen Poe."

In V. H. Jorgensen the taxpayer's testimony, remarkable though it was, was accepted by the court as approximating the truth. Despite the fact that the taxpayer had borrowed money paying 6-12 percent interest, during the period of the existence of the hoard, and that financial statements submitted to prospec-

Perhaps more significant in the conclusion that the accumulation was due to the taxpayer's frugality was the lack of proving any source of taxable income which would account for the additional income computed on the net worth method.

81Richard F. Smith, supra note 64.
82Arlette Coal Co., Inc., 14 T.C. 751 (1950).
83J. E. Wheeler, supra note 80.
86V. H. Jorgensen, supra note 76.
tive creditors failed to take into consideration the cash hoard, the court was convinced by the candor and attitude of the witness.

The case of Ralph Pate\(^87\) is more typical of the cases where the taxpayer has been successful in proving the cash hoard. The two elements which helped the taxpayer were corroboration and lack of a likely source. On the first point, his story was that the money was given to him by his father who was an escaped convict living in Canada. The taxpayer had the benefit of his wife's corroborating testimony, trips to Canada, the sheriff had warned him about keeping large sums in his safe, his banker testified that he kept a large amount in the bank's vault for him. The cash hoard story was not only corroborated by the above evidence but was alleged by the taxpayer in his first interview with the revenue agent. The court held that the taxpayer's story was rendered more credible by the entire lack of any evidence from which could be inferred a possible source of such large income during the years in question. The filling station that the taxpayer operated was small and located in a rural area and it was not probable that the increase in net worth arose from this source.

It is submitted that when the government fails to negate the existence of a cash hoard it is because of the inability to point to a likely source from which such income could have been earned. In regard to this point the court stated:\(^88\)

We do not mean to say that evidence of a likely source from which the taxpayer could have derived the currently taxable income attributed to him by the net worth computation is an indispensable requirement in a routine case of deficiency. What we do say is that it is a circumstance to be considered. When the government rests its case solely on the inference of net worth computations and the records present no evidence of a likely source of such currently taxable income, then the cash hoard story initially asserted and consistently maintained, gains additional cogency.

\(^87\)P-H T.C. Memo. ¶ 57,059 (1957).

\(^88\)Ibid.
3.

**Proof of a Likely Source of Income**

The inference which is alleged from an increase in net worth is that such increase is the result of currently taxable income. However, the net worth method merely shows an increase and in the absence of the proof of a likely source of income the showing of an increase is equivocal since it does not directly relate this increase to the receipt of income; on the other hand the increase might just as well be the result of a gift or inheritance. Because of this equivocal meaning attached to a net worth increase, the question arises as to whether the Commissioner must show a likely source of income when using the net worth method. Before an answer can be given to this question it is necessary to take cognizance that the failure of the Commissioner to prove the source of unreported income may not establish more than that the source is well hidden.90

The present position of the courts on this issue is that proof of a likely source of income is not required in the case of a mere deficiency. "Lacking the cooperation of the taxpayer, it may be impossible for the Commissioner to ascertain the source of the unreported income so determined, but the showing of such source is not an essential prerequisite for sustaining a deficiency..."91 The government's case need not fail because of the absence of such showing; however, as already indicated in the previous section, the failure to show a likely source may add credence to the taxpayer's defense of a cash hoard. In deficiency cases the burden cannot be shifted to the Commissioner by concealing the origin of the unreported income. The Commissioner's determination is presumptively correct and the taxpayer has the burden to show that the alleged increase is non-existent or the result of a cash hoard, gift or inheritance.

With respect to civil fraud, where the burden is on the Commissioner, it was once widely believed that the government must establish a specific source of income to account for the net worth

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increase. This view obviously would be a protection to those receiving income in the form of bribes and other nefarious activity in which records are not kept and where very little, if any, direct evidence is obtainable. Also where the source is alleged to be the same business as that shown on the returns, in actuality the issue is really the question of the adequacy of the records. Thus, in such cases it would be necessary for the courts to rule on the adequacy of the records, that is, it would be necessary to show that unreported income might have come from the taxpayer's business.

The *Holland* case quelled the argument concerning the use of the net worth method in regards to the issue whether the books and records had to be proven inadequate. However, the Supreme Court also stated that proof of a likely source was sufficient to convict in a net worth case. In a subsequent case, however, the Supreme Court said that this was not intended to imply that a proof of a likely source was necessary in every case. Instead of proving a likely source the Commissioner may in the alternative prove the non existence of any likely source of nontaxable income.

Thus, the present position is that in civil fraud cases it is necessary for the Commissioner to prove the source of income or that all sources of nontaxable income be negated.

The alternative requirement, although it involves the proof of a negative, is not as insuperable as it appears. It has been held that the government is not required to negate every possible source of nontaxable income—a matter peculiarly within the knowledge of the taxpayer. It is sufficient if he negates as possible sources of unreported increases in net worth all those nontaxable sources indicated by the taxpayer.

As in a mere deficiency assertion the taxpayer in a fraud case must come forward with an explanation; however, this is not the same as shifting the burden to the taxpayer. The Commis-

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93 Gordon, *supra* note 69, at 825.
sioner must by clear and convincing evidence rebut any allegation that the taxpayer may make in regards to the origin of the net worth increase. If he fails to do this, the fraud penalty cannot be imposed. However, under the same facts the taxpayer's story may not be convincing enough to be accepted and thus the deficiency assessment will stand because of the presumptive correctness of the Commissioner's determination.

Where it is necessary to show fraud to remove the statute of limitations if there is a failure on the part of the government to prove a likely source and where it has not clearly and convincingly negated the proof of possible sources of income, the deficiency is not entitled to the presumptive correctness and must also fall.97

4. Apportionment Over Several Years

The basic premise of the net worth method is that income is reflected in the amount that the net assets increase, with suitable adjustments, over the period involved. The major weakness of the method is that it does not relate the increase to any specific year. Of course the problem does not arise where the government is able to establish the beginning and ending net worth for each taxable year under consideration; however, in most cases the net worth computations cover a period of successive years and it is then necessary to make an allocation of the income over the period.

Little more than mention was made of this problem in the Holland case although the Court did take cognizance of the problem and said a reasonable allocation had to be made. The Court, however, offered no suggestions on how to make this reasonable allocation. In case of criminal fraud an erroneous allocation may result in a taxpayer being convicted on counts of which he is innocent. However, a threat of misallocation is not too important in a criminal case inasmuch as sentences are usually concurrent, so that if the taxpayer is found guilty on any one count, he does not suffer by being found guilty on other counts. In addition the government is not required to prove that specific amount of tax evaded in a criminal case.98

98Burns and Rachlin, Trial by Net Worth, 33 TAXES 121 at 127 (1955).
In a civil case the allocation problem takes on different dimensions inasmuch as a specific deficiency must be computed. The amount of the tax due under the Code is to be computed on an annual basis, and there is no authority in the Code for a complete disregard of the principal that each year is a separate taxable unit.

In civil cases it is necessary to distinguish if the allocation is being used to disclose a mere deficiency or a deficiency coupled with fraud. In the latter case peculiar problems arise and the general rules applicable to allocations for deficiencies cannot be followed.

The prerequisites for approximation used by the Tax Court are: that the item affects the taxpayer's liability, that the income was in fact earned and that evidence affords some basis for approximation or allocation. Obviously the first two prerequisites are met in a net worth case, and attention is directed at this time to what constitutes a reasonable basis for allocation in a civil case involving only a deficiency.

Since the net worth method does not show the year in which the income was earned the alternative methods of allocating the increase can be enumerated as follows:

1. The expenditures made for assets are considered as income in the year in which the expenditure is made.

2. The increase in net worth can be apportioned over the period under consideration by a mathematically even approach.

3. The increase can be allocated by such method that is applicable to the taxpayer that results in an allocation which has a reasonable likelihood of being correct.

The effect of a misallocation in the case of a mere deficiency would be to place income in a year upon which collection is barred by the 3 year statute of limitation or to bunch income in a particular year and suffer the taxpayer to pay a larger surtax.

100W. A. Shaw, 27 T.C. 561 (1956).
1013 P-H 1961 FED. TAX SERV. ¶ 21,303.
Practically speaking it is the latter consequence that is the more probable inasmuch as the first consequence would require the beginning net worth to be computed for a year which would normally be closed by the statute. The government would be most reluctant to do this unless it had additional evidence of fraud so as to remove the 3 year period of limitation.

Categorically none of the three alternative methods of allocation can be eliminated. The Commissioner’s determination is prima facie correct and the burden of proving that the deficiency was in an amount less than that on which the deficiency has been computed is on the taxpayer.

The Cohan case, although not a net worth case, is the leading case which has been applied to cases requiring allocations and approximations. The effect of the Cohan rule is that if the taxpayer chooses not to keep books to record his business transactions, or preserve records and data from which exact computations can be made, he bears the responsibility for the consequent lack in estimating his tax. If the result is an approximation subjecting him to a higher tax, the lack of exactitude is traceable to the taxpayer’s own failure to keep accurate accounts.

Although anachronous allocation is inherent in any case where a taxpayer fails to maintain full and adequate records the court will avoid such result whenever possible. Thus the court was unwilling to conclude that an expenditure in the amount of $10,000 for a United States Bond, Series G, was income in the year in which the purchase was made. It was thought that such an assumption would be unrealistic considering the small business that the taxpayer was conducting. However, if the allocation is based on time of expenditure there would seem to be no objection if distortion is not evident or if the taxpayer doesn’t offer a more precise method of allocation. Where the allocation method used was based entirely upon the time of expenditure and this resulted in a great difference in the taxes

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105 Ameen Jacob, P-H T.C. Memo. ¶ 50,126 (1950).
assessed in the various years, the court evenly distributed the increase because there was evidence that the taxpayer’s earnings were about equal in each of the taxable years.106

Where the Commissioner resorted to a purely mathematical division in distributing the increase among three taxable periods in proportion to the number of days in each period, the court said, “In the absence of the availability of any more precise method of dividing the total income among the three taxable periods we cannot say that the Commissioner’s method was erroneous.”107

Where the government found a cash hoard in a safe deposit box, this income was allocated on the basis of the dates the bills were issued by the Treasury Department. The net worth method was not accepted in this case for reasons other than that based on the manner of allocation. This allocation method appears quite arbitrary; however, under the presumptive correctness of a deficiency determination coupled with the rule in the Cohan case, legally, it is not an unreasonable method unless the taxpayer can show gross distortions.

In Veino v. Fahs108 a cash accumulation of $70,050 found in a safety deposit box was apportioned to the various taxable years equally according to the number of visits the taxpayer had made to his safety deposit box during those years. The defense in this case was that the cash was accumulated prior to 1922, that favorite cash hoard story. (This was not a fraud case but no statute of limitations problem was involved because of the failure to file returns.)

In rejecting the Commissioner’s contention that the increase should be allocated to the years in which the funds first appeared in the form of tangible assets, it was held that the unreported income for the period should be distributed throughout the period in a manner best reflecting the likelihood as to attribution of this unreported income to the years in which it was actually earned. The method used by the court was the ratio the annual reported cost of goods sold bore to the total reported cost of goods

sold throughout the years under consideration. This method of allocation renders a more probable result as it pinpoints the income with the source, namely, the mercantile business which the taxpayer conducted.\textsuperscript{109}

Where the burden of proof is on the taxpayer to rebut the presumptive correctness of the deficiency the government may merely find the beginning net worth and the ending net worth and allocate the total increase under the guidelines enunciated above. However, where the allocation apportions income to a taxable period that would normally be barred by the 3 year period of limitations the Cohan rule initially is not applicable. In such a case the government must show not only that there were deficiencies for the years barred but that such deficiencies were due to fraud.\textsuperscript{110} Since fraud must be shown by clear and convincing proof, it is axiomatic that a mere increase in net worth does not constitute that quantum of proof to show fraud. In fraud cases it is necessary to accurately allocate the increase to coincide with the fraudulent conduct inasmuch as "(t)he increase in these assets may have occurred entirely in one year and the fraud might have been consumated solely in that year ... Where the issue is fraud, we cannot assume that such fraud occurred in each of the years in issue rather than solely in one."\textsuperscript{111}

The government need not show the precise amount of the deficiencies, for that is not part of the burden of proving fraud; however, it must be shown that at least some part of the deficiency for each year in question was due to fraud with intent to evade taxes.\textsuperscript{112}

If the government meets its burden of proof of establishing fraud for each of the years in question which are otherwise barred by the 3 year statute, the correctness of the deficiencies determined will be presumed. Actually the method of allocation will not differ from that employed in cases involving mere deficiencies; however, a condition precedent to the allocation is the establishment of the fraudulent conduct.

\textsuperscript{109}Ruben v. Nicholas, 56-1 USTC \( \|$ \) 9522 (1956).

\textsuperscript{110}Benjamin Swede, P-H T.C. Memo. \( \|$ \) 60,166 (1960).

\textsuperscript{111}W. A. Shaw, 27 T.C. 561 (1956), affirmed 252 F. 2d 681 (C.C.A. 6th).

\textsuperscript{112}Ibid.
If the amount of gross income omitted is greater than 25 percent the period of limitations is extended to 6 years. Unlike the 5 percent negligence penalty, the burden of showing that the amount omitted exceeded 25 percent of gross income is on the government. The Commissioner rarely seeks to extend the period of limitations because of failure to omit 25 percent of gross income in net worth cases. Perhaps the reason for this is that the Commissioner is unwilling to take on this additional burden of proof. True, he has the burden of proof in fraud cases, but there he needs to show fraud and not the precise amount of the deficiency. To extend the statute because of a 25 percent omission, the Commissioner would have to properly allocate the increase in net worth to the proper taxable year and show that the deficiency in that year was greater than 25 percent. Were he to seek such an extension and the cash hoard defense were asserted, the burden would be on the government to show that the cash hoard was not greater than that used in the government’s computations. Here again an anachronous situation occurs. The government’s beginning net worth figures are received as presumptively correct and a deficiency is imposed for a taxable year not barred by the 3 year statute of limitations; however, using the same net worth figures to go beyond the 3 year bar, the court concludes that the figures used to prove the deficiency for the year not barred by the 3 year period is not wrong but hasn’t been proven correct by the government, therefore, the statute isn’t extended to 6 years.

V.

Conclusions

"The willingness of the average taxpayer voluntarily to pay his correct tax depends to a large extent on his belief that it is his duty and the right thing to do, and this willingness is kept high by the knowledge that all others are paying their fair share." Thus special measures must be taken to guard against those who willfully attempt to evade payment of their taxes. The net worth method is one of the important tools of enforcement used to

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114 Ibid.
115 ANNUAL REPORT, Commissioner of Internal Revenue 12 (1954).
accomplish this. Originally the method was used by the government to corroborate a deficiency and now is being used to show the deficiency. "The net worth method, it seems, has evolved from the final volley to the first shot in the Government's battle for revenue, and its use in the ordinary income-bracket cases greatly increases the chance for error."116

The criticisms of this method can be enumerated as follows:

1. The net worth statement prepared by the government is not a true net worth statement, but rather a statement of visible assets listed at cost less known liabilities. This is necessarily true inasmuch as the tax consequences cannot take into consideration depreciation (unless business assets are involved) nor can it take into consideration appreciation unless there has been a realization of such appreciation by sale or transfer. This criticism is not aimed so much at the use of the method as pointing out that the nomenclature could be more descriptive.

2. The net worth method does not accurately reflect annual income if the statement covers a period of taxable years. The major consequence of this distortion is where the government seeks to remove the bar of the statute of limitations.

3. The major criticism is that the method is vulnerable in proving the amount of beginning cash. As has been pointed out previously, the revenue agent, knowing this, will almost always attempt to get some commitment out of the taxpayer or his representative concerning this point in the initial interview.

In regards to cash hoard allegations, and it seems certain that many people have been led by a variety of reasons to keep cash accumulations in safety deposit boxes or in their homes, safeguards must be erected to protect the innocent taxpayer caught in this position. In a fraud case the proof of a likely source of income or negating sources of alleged nontaxable income is a requirement of the method to protect the taxpayer.

Another safeguard which would protect the innocent taxpayer who alleged a cash hoard would be the acceptance of the results of polygraphic test results into evidence. In the recent Robert

Zimmerman case\textsuperscript{117} such testimony was offered but the government's objection to this introduction was sustained. The taxpayer made a proffer to the effect that if the witness were allowed to testify he would state his opinion that taxpayer was telling the truth about the cash hoard, and that the results of the lie detector test firmly indicated the truth of this statement.

The apparent rationale for rejection of polygraphic test results is that the admission of this type of evidence would substitute such evidence for the province of the jury. Although such evidence is relevant it is not conclusive inasmuch as such equipment is subject to error. Since polygraphic results are not sufficiently accurate, it is felt that the jury would be unduly influenced by the results without taking into consideration the fallibility of the lie detector.\textsuperscript{118}

It has been suggested\textsuperscript{119} that the rationale is not persuasive in a Tax Court proceeding because of the absence of a jury and that such evidence should be admitted since the judge is experienced in weighing and attaching appropriate significance to the various types of evidence presented.

Were such evidence admissible in Tax Court cases, an additional safeguard would be offered to the innocent taxpayer not only in regards to the fraud aspect but also the deficiency where the burden is on the taxpayer.

The proffer made in the Zimmerman case was undoubtedly made for the purpose of establishing the groundwork for a subsequent appeal on this issue. Such appeal proved unnecessary. The Tax Court concluded that there was no deficiency as the Court believed the taxpayer's books and records accurate and that all sales transactions were correctly recorded. Perhaps the proffer served more than one purpose!

\textsuperscript{117}P-H T.C. Memo. ¶ 60,257 (1960).
\textsuperscript{118}Hobbet, Tax Court Net Worth Case Rejects Lie Detector Test on Cash Hoard, 12 J. TAXATION 102 (1960).
\textsuperscript{119}Ibid.