February 2018

Net Worth Method of Prosecution for Tax Evasion

Dean Borthwick

Follow this and additional works at: http://repository.uwyo.edu/wlj

Recommended Citation
Dean Borthwick, Net Worth Method of Prosecution for Tax Evasion, 10 Wyo. L.J. 138 (1956)
Available at: http://repository.uwyo.edu/wlj/vol10/iss2/6

This Comment is brought to you for free and open access by Wyoming Scholars Repository. It has been accepted for inclusion in Wyoming Law Journal by an authorized editor of Wyoming Scholars Repository. For more information, please contact scholcom@uwyo.edu.
The constitutional question is an open one so far as the Supreme Court of Wyoming is concerned. As just demonstrated, there is ample authority that the statutes are valid, but there is also logical enlightened authority that the statutes are unconstitutional and hence void.

From the standpoint of physical anthropology there is also another criticism of the statutes in that the classifications are often on a cultural or geographical basis rather than on the racial basis upon which they purport to be founded.

In terms of legislative trends the existence of the statutes is inconsistent with the policy of the Wyoming Legislature evidenced in recent years. The 1955 Wyoming Legislature repealed a statute which had provided for optional segregation in Wyoming schools. The same legislature adopted "Equal Rights" as the state motto. When a Civil Rights Bill was introduced it was defeated on the grounds that tolerance is desirable but it cannot be forced by legislation.

The Wyoming statutes probably serve little purpose other than as a source of harassment and uncertainty to those who have violated the provisions. The writer has not been advised of any prosecutions which have been instituted thereunder in Wyoming, and in the absence of additional circumstances it is believed that few county attorneys would be disposed to prosecute. As pointed out, the statutes can probably be avoided if the couple marries in a state which has neither a miscegenation statute nor the Uniform Marriage Evasion Act. This leaves the prohibition of the statute as a burden only upon those who lack the money to go out of the state to be married, those who do not know of the existence of the statute or how to avoid its provisions, and those who are not concerned with the inheritance of property. As a deterrent to interracial marriages, the statutes are probable failures. As Edward Byron Reuter has observed in his book, Race Mixture, "the legislation itself probably has no effect whatever upon the rate of racial intermixture."

William E. Foster

NET WORTH METHOD OF PROSECUTION FOR TAX EVASION

Determination of a taxpayer's income by indirect means in a tax evasion prosecution has increased considerably in the past few years. In very few recent cases has unreported income been shown by specific or direct proof of unrecorded transactions. The so-called "net worth" method of proof seems to be the indirect means most frequently used by the Bureau of Internal Revenue. It is apparent that they apply it now in

57. Reuter, Race Mixture, 103.
almost all criminal cases and in a high percentage of civil cases as well. This method of determining the liability of a taxpayer is an established practice of the government and has received the sanction of courts in many cases. Therefore, it has become increasingly important for lawyers to understand the legal and accounting principles upon which this method rests.

This note will be confined to a discussion of the net worth method as used in fraud or criminal cases.

In applying the method the Government reconstructs the net worth of the taxpayer at the beginning and at the end of the year in question, treating the increase in net worth, plus non-deductible disbursements, minus non-taxable receipts, as income. If the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the Government contends that the excess represents unreported taxable income.

The leading case law in this topic is *Holland v. United States*,1 handed down recently by the Supreme Court, along with three companion cases,2 wherein it outlined the broad principles governing the trial and review of cases based upon this theory.

The Government's right to employ the net worth method is not based on any specific statutory authorization; however, its use is derived from Section 41 of the Internal Revenue Code.3 This subdivision provides that the tax agents, in computing net income, are required to use the method of accounting regularly employed in keeping the books of the taxpayer. If no such method of accounting has been employed, or if the method does not clearly reflect the income, the computation may be made by such method, as in the opinion of the Commissioner does clearly reflect the income. When using the net worth method the Government must show the inadequacy of the taxpayer's books and records.4 Some courts have held that the net worth method of computing income may be used only where the taxpayer does not keep books, or where his books are inadequate in that they do not clearly reflect his income.5 A California court refused to use the net worth method in prosecuting a lawful Nevada gambler whose bookkeeping methods were of common use in the profession in that state.6 Furthermore it pointed out that the use of this method is limited to cases where there were no books of account kept in the ordinary course of business or where books were not kept in the manner in which a person engaged in legitimate enterprise would keep them. But the *Holland* case

---

5. *Remmer v. United States*, 205 F.2d 277, 286 (9th Cir. 1953); *United States v. Williams*, 208 F.2d 437, 498 (3rd Cir. 1953).
refutes these contended limitations. The court ruled that the provision, "net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer . . .", relates only to the method of accounting used by the taxpayer in his records and is not to be construed to require proof by the government of false or inadequate bookkeeping as a foundation for the use of the net worth theory. The court added that the net worth technique is not a method of accounting at all, except in so far as it calls upon taxpayers to account for their unexplained income.

When the Government relies upon circumstances of increased net worth in excess of reported income to establish income tax evasion, the basic net worth at the beginning of the tax year must be clearly and accurately established by competent evidence.\(^7\) A starting point from which to calculate future increases in the taxpayer's assets is of course very essential because the correctness of the result rests entirely upon the inclusion in this figure of all assets on hand at the outset.

The taxpayer usually contends that the net worth increase shown by the Government's statement is in reality not an increase at all because of the existence of substantial cash on hand which was not included.\(^8\) This defense asserts that the alleged cash was not expended for various reasons until the prosecution period. But the Government corroborates the certainty of its net worth computation by submitting evidence of the taxpayer's financial history prior to the years or years in question.\(^9\) From this evidence the jury may infer that a person who had substantial cash would not undergo hardship and privation. The possibility of accumulating cash can also be negated by going into the accused's income tax history.\(^10\) Income declared in previous years could be insufficient to enable a person to save any appreciable amount of money. Evidence of unexplained funds or assets in the hands of a taxpayer establishes a prima facie case of the understatement of income and it is then incumbent on the defendant to overcome the logical inferences to be drawn from the facts proved.\(^11\)

In the case of *Remmer v. United States*,\(^12\) reference was made during the trial to a certain safe deposit box in which the defendant purported to keep money. The taxpayer contended that the possibility that substantial funds were kept in the box destroyed the validity of the Government's net worth computations, yet he did not in any way at the trial prove that

---

7. E.g., United States v. Skidmore, 123 F.2d 604, 608 (7th Cir. 1941); Bryan v. United States, 175 F.2d 223 (5th Cir. 1949); Brodella v. United States, 184 F.2d 829 (6th Cir. 1950).
11. E.g., United States v. Hornstein, 176 F.2d 217, 220 (7th Cir. 1949).
12. Remmer v. United States, 205 F.2d 277, 287 (9th Cir. 1953).
said funds were in fact kept in the box. Other evidence introduced at the trial tended to show that defendant did not have substantial cash at the beginning of the prosecution period. Requests by the Government to examine the contents of the safe deposit box were refused. The court said that if a defendant could prevent a case of this type from being submitted to the jury merely by stating he had further assets not taken into consideration by the Government, yet refusing to disclose them, enforcement of the tax evasion provisions of the Internal Revenue Code would be completely frustrated. But when the Government rests its case solely on the approximations and circumstantial inferences of a net worth computation, the cogency of its proof depends upon its effective negation of reasonable explanations by the taxpayer inconsistent with guilt. Such refutation might fail when the Government does not probe relevant leads furnished by the taxpayer—leads reasonably susceptible of being checked, which, if true, would establish the taxpayer’s innocence. This does not mean that the Government must completely answer irrational explanations. In *Hooper v. United States*, the accused was being prosecuted for the years 1946 through 1951 inclusive. The defendant claimed that he had made substantial loans prior to 1927 that were repaid in 1945, 1946, and 1947 and that all such debtors had died since making such payments. The court ruled that this was not a reasonable explanation of his net worth increase. It felt that since there were no records of the alleged loans or support by any other corroborating evidence and especially in view of the long period which had elapsed between the time allegedly made and repaid, the Government was justified in omitting such items from their net worth computations. If the Government fails to show an investigation into the validity of reasonable leads, the trial judge may consider them as true and the Government’s case insufficient to go to the jury. This should aid in preventing unjust prosecutions. But the Government is not required to prove a negative or refute all possible speculation as to the source of the taxpayer’s asserted funds.

Another requirement in the use of this method is that there be evidence to support the inference that net worth increases are attributable to currently taxable income. Since the increases will include any sums received by the taxpayer as gifts, loans, inheritances and other non-taxable sources, proper allowance must be made for them. The taxpayer usually admits to the investigating agents that none were received. Also, the Revenue agents usually obtain the taxpayer’s own estimate of his living expenses, which sum they include in making their computations of income. Increases in net worth, standing alone, can not be assumed to be attributable

---

to currently taxable income. But proof of a likely source, from which the jury could reasonably find that the net worth increases sprung, is sufficient according to *United States v. Johnson*. This case held that proof of expenditures exceeding declared available resources was sufficient to support the finding that some unreported income was properly attributable to current earnings. The Government can not disregard explanations of the taxpayer which can reasonably be checked. Where no leads are offered, the Government is not required to negate every possible source of non-taxable income, a matter peculiarly within the knowledge of the accused.

In proving an attempt to evade income tax, it is not necessary that the Government introduce evidence as to the exact amount of the additional tax. To make a case for the jury, it is sufficient that the Government present substantial evidence from which the jury can find that beyond a reasonable doubt a substantial amount of net income was not reported. How much evidence must be offered by the prosecution depends on the facts of the particular case.

Although the Government has established an increase by the figures in its net worth computations, the crime of tax evasion does not automatically follow. The attempt must be willful, that is, done with the intent that the Government should be defrauded of the income tax due. Mere failure to make a complete and accurate report of income for taxation is not enough to support a verdict of conviction. A state of mind is, of course, very difficult to prove. But direct proof thereof is not essential. A willful attempt to evade income taxes may be inferred from the taxpayer’s concealment of assets or covering sources of income, handling of one’s affairs to avoid making records usual in transactions of the kind, and any other conduct, the likely effect of which is to conceal.

The charge to the jury should include a comprehensive and unified summary of the nature of the net worth method, the assumptions upon which it rests, and the inferences available both for and against the accused.

A net worth case is based on inferences drawn from circumstances. The jury is asked by the Government to infer that all of the taxpayer’s assets were included in the Government’s proof and that the increase in net worth represents taxable receipts which were willfully not reported. This has led many courts to be disturbed by the use of the method. But if, as pointed out in the *Remmer* case, a defendant could prevent a case

---

21. *United States v. Eshenck*, 126 F.2d 702, 704 (2nd Cir. 1942); *United States v. Chapman*, 168 F.2d 997 (7th Cir. 1949); *Gendelman v. United States*, 191 F.2d 993, 996 (9th Cir. 1951).
24. *Banks v. United States*, 204 F.2d 666, 672 (8th Cir. 1953); *Graves v. United States*, 191 F.2d 579, 583 (10th Cir. 1951).
this type from being submitted to the jury merely by stating that he had further assets not taken into consideration by the Government, yet refusing to disclose them, enforcement of the tax evasion provision of the Internal Revenue Code would be completely frustrated. Congress has relied for the collection of income tax largely upon the taxpayers own disclosures. The Government should be allowed to use all legal evidence available to it in determining if the taxpayer's representations accurately reflect his financial history. In view of its widespread use, the Government deems the net worth method useful in enforcement of its income tax laws. Nevertheless, the courts should carefully scrutinize all aspects of a case in which circumstantial evidence as to guilt is the chief weapon of a method that is itself only an approximation.

DEAN BORTHWICK

DOCTRINE OF CORPORATE OPPORTUNITY APPLIED TO INTERLOCKING DIRECTORATES

The practice of energetic businessmen accepting directorates in several corporations during the same period of time is not a novel situation. However, with the upsurge in uranium activity, concurrent directorships are becoming even more common. In many cases an individual is not only a director in several corporations, but it is also found that the corporations in which he is a director have identical purposes, i.e. the exploration for and production of uranium ore, or oil, or other minerals.

Consider the following hypothetical. P, a promoter of uranium ventures, discovers certain uranium deposits. In an effort to develop these deposits, P organizes a corporation for the purpose of raising the necessary money from the sale of the corporate stock. Since P was instrumental in organizing the corporation, he will ordinarily be offered the position of director if not that of officer. Over a period of years the average promoter will repeat this procedure many times, and as a consequence will find that he is an active director in several corporations with similar if not identical purposes. Because the stock for the several corporations is normally sold publically and at different times, the stock ownership of the various corporations will generally be vested in separate groups of stockholders whose interests are in competition. What is P to do when in the usual course of his business he obtains knowledge of a newly discovered uranium deposit which is likely to prove of great value? If the doctrine of corporate opportunity is applied, it would appear that P has the duty of

1. Olson v. Basin Oil Co. of California, 288 P.2d 952 (Cal. 1955). This is a recent illustration of a promoter who became a director and officer in several corporations with similar corporate purposes.

2. Blaustein v. Pan American Petroleum & Transport Co., 263 App.Div. 97, 31 N.Y.S.2d 934, 962 (1941); Turner v. American Metal Co., 36 N.Y.S.2d 356, 370 (1942). These cases state the doctrine of corporate opportunity as follows: "... one who occupies a fiduciary relationship to a corporation may not acquire, in opposition to the corporation, property in which the corporation has an interest or tangible expectancy