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FEDERAL INCOME TAX FRAUD

JOSEPH B. BYRNES

UNDER OUR SYSTEM of federal income taxation the taxpayer acts as his own assessor in that he reviews his transactions, computes his tax, prepares his return and remits whatever tax may be due, or claims a refund of tax already paid, as the case may be.

At first blush such a system would seem to indicate such a degree of trust upon the part of the government as to amount to naïveté. But this is not so. Under the provisions of the Internal Revenue Code, the officers of the Treasury Department are given the power to examine the books and records of the taxpayer and related persons for the purpose of determining the liability of the taxpayer and to assess the correct tax.[1] This examination may be made at any time within three years after the return is due,[2] except that if the taxpayer has failed to report as part of gross income a sum in excess of 25% of gross income as stated in the return, an examination may be made at any time within six years of the filing of the return.[3] By agreement, the taxpayer and the government may extend the period for examination and subsequent assessment.[4]

The examination of the taxpayer's return is made by a revenue agent, either by a field audit or by an office audit of the taxpayer's returns and related records. Such audit procedure follows a preliminary survey of all returns filed for the purpose of selecting those to be subjected to examination either by reason of various items appearing therein, the amount of income disclosed or by a desire on the part of the government to apply sampling techniques to what may appear to be innocuous returns.

A field audit involves a fairly complete examination of a taxpayer's return at his place of business and is ordinarily undertaken in the case where the related records would be too voluminous for examination

[1] Internal Revenue Code of 1954, 68 A. Stat. 901 (1954), 26 U.S.C.A. 7602 (1954).

[2] Ibid. at § 6501 (a).

[3] Ibid. at § 6501 (e).

[4] Ibid. at § 6501 (c).

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at the offices of the Internal Revenue Service. An office audit involves the summoning of the taxpayer to meet the revenue agent at the latter's office and there to explain and justify relatively minor items appearing in the taxpayer's income tax return.

As delineated by the statute, the purpose of the examination is to determine whether the tax disclosed upon the return is correct. This, of course, depends upon whether the taxable income reported is correct. Taxable income, in turn, is a net figure arrived at by the interplay of items of income and deductions. The revenue agent devotes himself to a review of these items and the related records to see whether the figures are substantiated in fact, and whether the appropriate provisions of the Internal Revenue Code governing the inclusion of income and the propriety of deductions have been observed by the taxpayer.

At the conclusion of the examination the revenue agent informs the taxpayer of the results thereof. The information imparted may be good news to the effect that the return as filed will be accepted or, very rarely, that the taxpayer has paid too much and will receive a refund of the excess tax paid. More often than not, the agent will inform the taxpayer that there exists a deficiency in tax based upon a deficiency in taxable income as determined by the agent on the basis of disallowing certain deductions claimed by the taxpayer or of including certain items of income omitted by the taxpayer, or both.

Confronted by a deficiency, the taxpayer may agree to an immediate assessment of the additional tax together with interest thereon at the rate of six percent from the due date of the return. In the alternative, he may contest the issue of deficiency and pursue his remedies through the various administrative levels of the Internal Revenue Service and through the courts until such time as a final determination is made of the matter. Absent fraud on the part of the taxpayer, there will be no addition other than interest to the deficiency in the tax, unless it be determined that part of the deficiency is due to negligence on the part of the taxpayer, in which case a penalty of five percent may be imposed upon the entire deficiency.[5]

From the foregoing it may be readily gathered that the trust reposed by the government in the taxpayer is far from unlimited and that the taxpayer's return is subject to scrutiny and review toward the end of bringing it in line with internal revenue laws and regulations, even in

[5] Ibid. at § 6653 (a).

a case where the taxpayer has acted innocently or ignorantly and without any provable desire not to render unto Caesar his due. What then of the taxpayer whose return is incorrect not on the basis of mistake but on the basis of deliberate intent not to pay the tax that he knows to be due the government? What sanctions exist in such a case and what can the government do in seeking to apply these sanctions?

This leads to a consideration of fraud under the internal revenue laws. In this connection fraud differs not at all from fraud in the general sense of the term. Essentially it involves a knowing misrepresentation of a material fact to the detriment of one who has the right to rely upon the representation. With respect to a federal tax return these elements are found present and accounted for when the taxpayer represents to the government by his return as filed that for a given year his income was so much and his tax thereon was so much, when he actually knows that for the period in question he had a taxable income in excess of that reported and a tax thereon greater than that declared. Parenthetically, it may be remarked that this substantially is the language of the charge set forth in the usual income tax indictment.

Income tax fraud is a crime. As such it involves the element of intent, the *mens rea*. Absent intent, fraud does not exist. In many routine examinations the agent may suspect that fraudulent intent has inspired certain deductions subsequently disallowed in whole or in part because of a lack of substantiation. However, the absence of corroborating records does not connote the presence of fraud as an inevitable conclusion, with the result that many taxpayers who have padded deductions with minor larcenous intent avoid dire consequences because of the lack of adequate proof to establish their guilty purpose.

Proof of intent, therefore is a *sine qua non* in a case of criminal fraud. Obviously, as in many other types of criminal cases, such proof is often necessarily inferential or circumstantial, since the transgressor in a crime of deceit does not ordinarily proclaim loudly to the world either his intent to defraud the revenue or the *fait accompli*. Merely negative acts such as the omission of items of income, or affirmative acts such as the claiming of unsubstantiated deductions, do not in themselves ground the element of intent. Rather, there must be proof of design and evidence of a pattern underlying the actions of the taxpayer to obviate the equally tenable conclusion that the taxpayer's derelictions were the result of inadvertence, ignorance or negligence.

The "badges" or indicia of fraud are aptly described by Mr. Justice Jackson in *Spies v. United States*,[6] a landmark in the long range of decisions on criminal tax fraud:

> ... By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax evasion motive plays any part in such conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime.

At this time it would be well to discuss and to differentiate, so far as is possible, two terms often encountered in the field of federal taxation. One is "tax avoidance" the other, "tax evasion." Practically, the most important distinction is that the one is permissible if not praiseworthy, while the other is subject to criminal prosecution. Despite Mr. Justice Holmes to the contrary,[7] the ordinary person seeks to minimize his tax liability and the *desideratum* in all tax "planning" is the ideal of eating one's cake and having it, too. To the extent that the goal is approached within limits permitted by law, we have tax avoidance. Should the strategem go beyond the law, tax evasion or fraud ensues.

To illustrate. The taxpayer in the current year has realized substantial capital gains, his only income for the year. For the coming year, he expects only ordinary income, i.e., income from wages, interest, dividends, etc. He is the owner of certain securities which now have market value far below their purchase price and which, if sold, will result in a loss greater than his gains. No reasonable hope for an appreciation in their value exists. With tax avoidance as his motivation, the taxpayer will sell his depreciated securities, wipe out his capital gains, render himself nontaxable for the current year and carry over his capital loss to reduce income for the coming year. If he wished blindly to follow the ideal of Holmes, he could defer the realization of his loss until the coming year, pay his tax on his capital gains for the current year, and pay a tax on the income of the coming year reduced only by that part of the capital loss available to him under the first course of action. One way or the other, the taxpayer has acted legally, and the only question is whether the payment of additional tax is a

[6] 317 U.S. 492 (1943).

[7] "I like to pay taxes. With them I buy civilization."

work of praiseworthy supererogation. Possibly the best comment in that regard is that of Judge Learned Hand:

> Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[8]

Now assume that the taxpayer has hopes that the depreciated securities will increase in value. He still wishes to eliminate his capital gains and so, not too originally, reports a fictitious sale of his "cats and dogs," naming as the purchaser either a non-existent person or some one who in effect is merely his nominee. Here, quite obviously, is a situation different from legitimate tax minimization or avoidance. In the instant case we have evasion and fraud in that the sale is a sham and there is a misrepresentation of what purport to be the facts.

Often the distinction between avoidance and evasion is difficult to draw. Assume in the illustration given above that the taxpayer sells his doubtful securities to his wife. On the authority of Sec. 267 I.R.C. the tax avoidance would fail and the loss would be disallowed because of the relationship between vendor and vendee. As to whether the transaction should be regarded as evasion would depend upon whether it falls within the ambit of the remarks of Mr. Justice Jackson in the *Spies* case. In other words, if the transaction was genuine in fact, if the wife actually paid her husband the selling price and if the husband honestly believed that he might claim the loss, no criminal sanction should follow. On the other hand, if no payment was made by the wife, if the securities were never transferred of record and if all the circumstances surrounding the transaction created an aura of falsity, the inference of evasion rather than of avoidance would be well-founded.

No question exists that the motivation for both avoidance and evasion is mercenary. The distinction is both objective and subjective as evidenced by the methods employed and the mental and volitional approach of the taxpayer in choosing the methods. It is not impossible to conceive of a taxpayer with the intent to evade accomplishing his purpose by perfectly lawful means and thus avoiding punishment. The occasional tragedy is that of the taxpayer, *sans peur et sans reproche*, losing his way in the mazes of the tax laws and fighting the accusation of fraud despite the purity of his intentions. Comparable would be the case of the man deliberately placing his automobile in a restricted parking zone at a time when unknown to him the prohibi-

[8] Helvering v. Gregory, 69 F. 2d 809 (C.A. 2d, 1934).

tion does not apply, and that of the unwary motorist failing to see the direction marker as he innocently drives down a one-way street against oncoming traffic.

Without question many minor tax frauds pass without detection, while others result merely in disallowances of the items involved because of lack of substantiation. Typical would be unwarranted increases in deductions claimed for charitable contributions or travel and entertainment, items for which complete substantiation does not ordinarily exist. A frequent device employed by the small taxpayer imbued with a desire to save taxes is claiming a dependency exemption to which he is not entitled. This may involve the creation of a new entity or the listing of a family pet as a human being supported by the taxpayer. Periodic sampling techniques by the Internal Revenue Service and the impositions of penalties have had a restraining effect upon this fictitious philoprogenitiveness.

Obviously, sound common sense and the application of the *de minimis* principle forbid too much attention to the minor erring taxpayer. Nor is such attention necessary. The ordinary taxpayer is honest and seeks to file a correct return, and the aggregate peculations of small taxpayers probably do not bulk too large in these days of multi-billions collected in revenue. Moreover, there exists for the great number of taxpayers the standard deduction[9] which permits the blanket and unitemized allowance of ten percent of adjusted gross income, subject to a limitation of $1,000[10] in lieu of the itemization of so-called "personal" deductions. Without doubt, the standard deduction has removed temptation for many smaller taxpayers, thus saving them from possible penalties.

The type of fraud with which the government is concerned is that with some measure of magnitude, not that it follows that a small case may not receive attention with a view toward prosecution. In addition, the case selected is ordinarily one where the evidence of intent is clear or where reason exists to believe that such evidence can be developed or that the attempt in that direction should be made. Often enough, an investigation may be instituted largely on the basis of groundless suspicion, if one may believe the taxpayer involved.

The inception of a fraud case may occur during the course of a regular or routine audit of a taxpayer's return. The revenue agent assigned to the examination discovers certain items in the taxpayer's

[9] Internal Revenue Code of 1954, op. cit. supra at 141.

[10] $500 in the case of a married taxpayer filing a separate return.

records which point to the possibility that the return is fraudulent. Again, the taxpayer may become involved when an agent checks his records for verification of transactions with another taxpayer under examination. A "rap" letter may also trigger a fraud investigation. A disgruntled employee, a discarded mistress or even a wife may write a letter to the Treasury Department in which the charge of tax irregularities is made. Occasionally, a "crank" letter will be received and found to be fruitful. Some cases originate with items in the newspapers pointing to the display of means by persons of hitherto unknown wealth. Secretary Morgenthau, so the story goes, launched an intensive tax fraud drive in the middle forties when he saw extravagant spending at Florida resorts by persons alleged to have made fortunes in the black market. Finally, those people who live on the fruits of illegal and borderline activities are always potential subjects of investigation to determine whether they have failed to pay the tax upon their ill-gotten gains.

At this juncture, a word on the means or mechanics of fraud may well be in point. Taxable income, which is the measure of the tax liability, is a final figure derived from basic arithmetical computations involving items of income and deduction. Hence, the taxpayer seeking with fraudulent intent to understate his income, must necessarily distort the figures that combine to produce the final figures of taxable income. Basically, his maneuvers will fall into one or more of three broad categories. He may understate gross income, he may exaggerate deductions, or he may set up a false division of taxable income.

Understatement of gross income finds its expression most often in the suppression of sales. The taxpayer will simply omit certain transactions with customers and thus fail to include these in his receipts as reflected in his income tax return. The sales selected may be all or part of the cash sales, or they may include all or part of sales to certain customers on open account. Again, the taxpayer may have income from sources other than his known business, and this income does not find its way to the income tax return.

The overstatement of deductions needs little explanation. Items such as entertainment which rarely have full substantiation are increased to a point far beyond that which might be reached by fair estimate for expenditures not supported by records. Completely fictitious charges may appear and disbursements for personal expenses such as vacations, clothing and jewelry, may be present, disguised as business expense.

Another means which affects gross income by means of improper deduction is the overstatement of the cost of sales. This involves the juggling of inventories and perhaps of purchases in order to claim that goods sold have cost more than the taxpayer actually expended.

The diversion of taxable income derives its advantage from the progressive rates found in the income tax structure. A taxpayer in already high brackets can testify most eloquently on the law of diminishing returns since every dollar of additional income means less to him in terms of retention. So, if he is dishonest, he may set up a complaisant associate or employee as an ostensible partner in an enterprise, and arrange for that employee to receive a substantial portion of what is the taxpayer's own income. The person so chosen will make a return of the income received as his own, pay the tax upon it at a much lower rate than the dishonest taxpayer, and remit the balance to the instigator of the scheme. Rather rarely does the accomplice receive anything for his services. Again, diversion of income may be accomplished by having a nominee take sole title to income-producing property and remit the net proceeds after income taxes to the true owner.

Considerable ingenuity is displayed by dishonest taxpayers and many of them undoubtedly pride themselves on the schemes that they have devised. Unfortunately, however, it is almost impossible for a taxpayer to conjure up a scheme or stratagem that has not already come to the attention of the government. Solomon remarked that there is nothing new under the sun and there is certainly nothing new in terms of tax dishonesty, as a review of reported fraud cases will disclose.

It should not be understood from the foregoing that an income tax fraud case is transparent and that proof of fraud is easily come by. To the contrary. Tax fraud is a crime of deception, the person who practices it is ordinarily endowed with more than a fair share of native cunning, and every effort is made by him and those who, unfortunately, may lend him expert assistance, to disguise the crime. It is true that many attempts at fraud are stupid and easily discernible. The majority involve hard work by the investigating agents and some few cases cannot be "cracked." In almost all instances, however, the guilty taxpayer whose case is investigated will have a far from pleasant time, with more than a fair likelihood that his wrongful actions will result in heavy criminal or civil penalties or both.

Assuming that indications of fraud are found in the examination of an income tax return by a revenue agent or that information is re-

ceived to the effect that a certain taxpayer is guilty of evasion, what is the procedure followed by the government to investigate and determine whether fraud was perpetrated both as a matter of fact and a matter of law? Under these circumstances, the matter is referred to the Intelligence Unit of the Internal Revenue Service of the Treasury Department. The prime function of the Intelligence Unit is to investigate all cases involving alleged frauds under the Internal Revenue Code. Rare cases involve frauds with respect to gift, estate and excise taxes. The overwhelming majority of the cases handled deal with alleged fraud arising out of income taxes.

In a case where an agent has discovered indications of fraud during a routine examination, he immediately terminates his examination and confers with the special agent of the Intelligence Unit to whom the case has been assigned. If the case originates through information received by the Intelligence Unit, a request is made by the local head of that unit to have a revenue agent assigned to work with the special agent charged with the case. Assignment of the agents for purposes of collaboration on a case occurs only after a decision has been reached by supervisory officials that an investigation is warranted by some measure of probable cause.

Theoretically the special agent and the revenue agent have somewhat diverse functions leading to a common goal. The revenue agent is charged with showing that a deficiency exists in fact, in other words, with showing that an understatement of income, and hence of tax, exists. The special agent's responsibility is to establish that the understatement is fraudulent and criminal in that it stems from deliberate intent.

Actually the revenue agent and special agent work hand in hand and assist each other in furthering their respective functions. Details of the audit are primarily the job of the revenue agent, but where, as is the case more often than not, the special agent is well qualified in accounting and auditing procedures, the latter will often be found poring over books of account. So, too, with the investigative aspects of the case. These often involve an analysis of the records of persons with whom the suspected taxpayer has done business, with the result that the auditing skill of the revenue agent will be called upon to establish discrepancies between the taxpayer's records and those of persons with whom he has done business.

The question arises as to how serious is a referral of a taxpayer's situation to the Intelligence Unit. Unqualifiedly, the answer is that it is

most serious. Such a referral means that the government views askance the taxpayer's returns and proposes to make a most searching investigation to determine their truth or falsity. At the very best, it means, in the case of an innocent taxpayer (or one whose guilt cannot be established), a protracted inquiry which will reach every phase of the taxpayer's most secret life. At the worst, the taxpayer may have to stand trial, with the attendant anguish and notoriety, and the strong possibility of fine and imprisonment staring him in the face. In addition, whether or not indicted and convicted, he may receive a demand from the government for the taxes evaded, together with a fifty percent civil fraud penalty and interest from the date of filing the fraudulent return or returns.

As might be suspected, many criminal sanctions are found as penalties for attempted tax evasion. Reference to the individual income tax return, Form 1040, will disclose a certification that the return has been prepared under the penalties of perjury. This certification for ten years or more has supplanted the requirement of notarization, certainly a forward step. So, if the government elects, it may indict the erring taxpayer on this score and subject him to a fine not to exceed $5,000 or imprisonment not to exceed three years, or both.[11]

Ordinarily a taxpayer who is prosecuted for fraud will be indicted under Section 7201 of the Internal Revenue Code, which reads as follows:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than five years, or both, together with the costs of prosecution.

The foregoing statute is noteworthy in a number of respects. The qualification indicated by the word "attempts" is significant in that the defendant cannot plead the failure of his endeavor. Also of greatest importance is the phrase "any tax." By virtue of this generality of expression, the defendant may be found guilty when the tax in question is not his own. A typical instance is the one in which the taxpayer is charged not only with the attempt to evade his own tax but also that of a close corporation dominated by him.

Only time can give the dishonest taxpayer sanctuary from criminal prosecution. The statute[12] provides that a prosecution under Section

[11] Ibid. at § 7206 (1).

[12] Ibid. at § 6531.

7201 I.R.C. must be instituted within six years of the commission of the offense, i.e., the filing of the fraudulent return. So, if a fraudulent return was filed on March 10, 1956, the statute would run six years from that date rather than from April 15, 1956, the due date, assuming that the return was for a calendar year.

Evasion of tax is punishable not only by imprisonment and fine but also by the imposition of civil penalties. The statute[13] provides, in effect, that if any part of a deficiency is due to fraud, there shall be imposed a penalty of 50 percent of the entire deficiency in tax. Since it frequently happens that a deficiency results not only from fraudulent acts of the taxpayer but also from adjustments to the return that are non-fraudulent or "technical," the effect of this penalty is to punish that taxpayer for errors that would merely result in additional tax in the case of an ordinary taxpayer.

Imposition of the 50 percent fraud penalty and assertion of the additional tax is never barred by the passage of time.[14] In other words, if fraud can be proved, the government may demand the additional tax and penalty at any time, even though the period has passed in which either a routine examination or a criminal prosecution may be instituted. The fraud penalty is exclusive of criminal action, with the result that its assertion will ordinarily follow the conclusion of a criminal trial for income tax evasion. Whether the taxpayer has been acquitted or convicted in a criminal trial makes no difference in a proceeding to assert the civil fraud penalty.[15]

In addition to the penalty and deficiency in tax, interest will also be demanded from the taxpayer. Often a fraud case may not be concluded in all its aspects until many years after the filing of the false return. As a consequence, the taxpayer, who may have spent several years in prison, may have a liability for interest and penalty equal to the tax deficiency. When it is remembered that through this entire period he has probably expended substantial sums for representation, it may well be doubted that he now has the feeling of satisfaction that he had when he filed the fraudulent return and contemplated his savings in tax.

The above summary of sanction depicts the fate of the dishonest taxpayer whose guilt can be established. The investigation conducted by the special agent and the revenue agent will be directed toward the

[13] Ibid. at § 6653 (b).

[14] Ibid. at § 6501 (c) (1).

[15] Helvering v. Mitchell, 303 U.S. 391 (1938).

imposition of the penalties if the facts disclosed tend to establish evasion on the part of the taxpayer. If the facts tend to the contrary, the case will be closed without prosecution, although the taxpayer may be subject to the civil fraud penalty if proof is available to that end. The taxpayer also may receive in effect a clean bill of health and be subjected only to routine adjustments of his return. Regardless of the result, the investigation will be thorough and even though the taxpayer may escape both prison and penalty, he will devoutly pray that he never again be subjected to the experience that he has gone through.

It is not to be supposed that the investigating agents necessarily have an easy time during the investigation. If fraud exists in fact, the offending taxpayer has done everything to conceal the evidence. Furthermore, the investigation differs from a routine examination in that the burden of proof is upon the government and not upon the taxpayer. Possibly, a qualification of the foregoing statement might be in order, at least as a practical matter, to the extent that the occasional taxpayer often will seek most vehemently to justify himself and so take the initiative by disclosing everything to the agents. Again, too, the occasional agent seems to feel that the burden of proof is always on the taxpayer and that the latter is guilty until such time as he can establish his innocence. Despite these instances, however, most fraud cases demand the utmost from the agents who often must labor literally for years to establish their case.

The fundamental economics of every item having an income tax consequence emphasize the vulnerability of the taxpayer who has gone astray. No one makes money by dealing with himself and no income is realized by transferring funds from one pocket to another. Whenever and wherever a profit is made or reason exists to claim a loss or a deduction, there must be a transaction between the taxpayer and another entity. If the taxpayer suppresses all records to an income-producing activity, ordinarily it may be expected that the other person involved will have something bearing upon what has happened and that, somewhere, the records of a financial institution will indicate what has happened. If a deduction is claimed, a payment is involved and the alleged recipient thereof will normally be able to shed some ray of light to confirm or disprove the alleged expenditure. Where profits have been received by another person under a doubtful claim of right, records should be available to establish both the right to receive and the retention of the sum in question.

In other words, since the taxpayer engaged in economic and taxable activity must have dealings with other persons, his misrepresentations concerning these dealings are, at least in theory and in usual practice, subject to refutation. With this as a guiding principle, the agents assigned to the taxpayer's case will review his transactions as reflected not only in his records but in the records of all with whom he has come in contact. His customers will be interviewed to determine whether the sales to them as reflected on his books are correct, and his suppliers will be checked to ascertain whether the deductions claimed by him in this connection agree with their records. In effect and in fact, the taxpayer's return and his supporting records are audited in detail and nothing escapes scrutiny.

Normally, if the fraud is relatively simple in plan and execution, serious discrepancies will appear. Customers will have furnished statements that their purchases were in excess of those shown by the taxpayer and suppliers will have denied most convincingly that their transactions amounted to the sums claimed. If the discrepancies are relatively numerous and extend over a considerable period of time, a pattern unquestionably exists and it is rather obvious that intent is pretty well established.

In the case of the more astute taxpayer, greater difficulty is to be anticipated. If income has been omitted, clues pointing to such omission will not be found in the taxpayer's records. Rather than show a partial record of sales to a customer the taxpayer will omit all reference to any transactions with the customer and will suppress completely all sales to that vendee. Cash sales may be radically understated and the taxpayer may claim as expenses many cash disbursements. Despite all this, the agents more often than not are able to establish quite definitely what actually happened and to reconstruct, or to construct for the first time, a reasonably correct profit and loss statement for the taxpayer and his true tax liability.

The method outlined above is what may be termed the "specific item" approach. By this method the government is able to show by the testimony of witnesses and, usually, corroborative records, that the items appearing in total upon the taxpayer's return are false, as are the figures reflecting taxable income and tax liability. For example, if the testimony of a number of persons is adduced to show that sales have been understated consistently, a fairly convincing prima facie case has been made out, and the taxpayer will be hard put to plead inadvertence or negligence as a defense.

An occasional case arises when the "specific item" method is not practical. This occurs most frequently in the case of the businessman who has had numerous small cash transactions that are not readily traceable, or in the case of the individual whose business activities are of such a nature that individual transactions are cloaked in secrecy. Typical of the first group is the small retailer who daily pockets a portion of his cash receipts and destroys his cash register tapes, or the professional man who religiously omits to record some of his cash fees. The outstanding examples of the second group are those persons who derive their income from illicit activities or those who have successfully operated in the past through the intermediary of nominees without any disclosure of their interests.

These latter cases where records of individual transactions are not available are approached by one variant or another of the "net worth" method. Reduced to simplest terms, this means that the taxpayer has a net worth or is "worth" more than is explainable in terms of his reported income and is therefore guilty of tax evasions. Perhaps the thought sought to be conveyed can best be understood by a rather elementary illustration, as follows:

Net worth, December 31, 1955			$30,000
Less: Net worth, January 1, 1955			10,000
Increase			$20,000
Income reported, 1955		$15,000	
Less: Income tax thereon	$3,000		
Living expenses	6,000	9,000	6,000
Unexplained increase in net worth			$14,000

In the above example the taxpayer's net worth has increased by $20,000 during the year 1955. Of this increase $6,000 is explainable as being available from the year's income after payment of income taxes and disbursements for food, clothing, shelter and the like. This leaves a balance of $14,000 deemed to be income for the current year unless the taxpayer can show that such is not the case or that the government has erred in its computations.

There can be little doubt that grievous is the lot of the taxpayer against whom the government has proved numerous suppressions of specific items of income. Just as grievous is the situation of the taxpayer who finds himself trapped by a convincing net worth computation. A mathematical demonstration is irrefutable and its conclusion unassailable *but* only if the figures are correct and represent what they

purport to represent. If one or more of the figures in a net worth analysis can be shown to be incorrect, the whole structure topples and with it the inference of evasion. If one weak spot can be found in the government's presentation of new worth, the taxpayer can loudly proclaim his innocence of everything. In a specific item case, to the contrary, refutation of one of a series of transactions still leaves the others dangling over the taxpayer's head.

In the example *supra*, the government has given the taxpayer an initial net worth of $10,000, a figure obtained from its investigation. If the taxpayer can show that this figure is incorrect and that his beginning net worth was greater, the unexplained increase in net worth decreases or may disappear. If he can show that his expenditures for living were less than the $6,000 set up by the government, he has provided additional funds to explain his increased wealth. If he can establish that in addition to the $15,000 reported as income for the year 1955, he received gifts and inheritances, which are not subject to income tax, he can fairly explain some or all of his net worth increase. Should the taxpayer show that he has unpaid loans not reflected by the government, he has gone far in establishing that the final net worth figure is not correct. Finally, if it is possible to show an error in valuation in the final net worth or that the taxpayer holds part of it as trustee or nominee, he has seriously damaged the government's case.

The consequence of the foregoing is that the government's net worth case is like a chain. Every link must stand attack and if the taxpayer can break but one link, the entire chain is damaged if not broken.

The so-called net worth case is in reality based upon the taxpayer's increase in net worth and his expenditures, using the latter term to mean funds disbursed for purposes other than the acquisition of assets. At times there will be found a government case based upon expenditures alone, without an increase in net worth. For example, if a taxpayer spends $50,000 in a given year, reports an income of $10,000 and has an initial net worth of $5,000, the inference of unreported income based upon expenditures is not unreasonable.

The measure of the increase in net worth may embrace many things. Often the chief or only item may be bank deposits. Examination of the taxpayer's bank accounts may disclose credits far in excess of those that may be accounted for in terms of reported incomes.

Often the bank accounts may be in fictitious names or in the names of nominees. It is true that bank deposits in themselves are not taxable income, but if the deposits can be related to economic activity, the government will be held to have made out its case to the extent that the deposits exceed reported income.[16] The burden then becomes that of the defendant to show that the deposits do not represent income and are explainable as non-taxable items, such as gifts, the proceeds of loans payable or loans receivable or that, actually, the money involved is not that of the taxpayer but of some one else for whom he is holding it.

The development of the net worth approach to income tax cases has posed some interesting problems as to how far the government must go and what it must establish to constitute a prima facie case. At all times, of course, the burden is upon the government to prove its case beyond a reasonable doubt. The application of this fundamental rule to net worth cases, however, has resulted in conflicts of decisions, with the government generally prevailing. Notable exceptions were the *Fenwick*[17] and *Bryan*[18] cases, in which it was held that the government had failed to sustain the required degree of proof.

The Supreme Court had, in 1943, approved the use of the net worth method in a case involving a gambler without records of his activities.[19] The increasing use of the net worth method in later years was extended to cases where the taxpayer has had records but where the government has contended these records were inadequate to reflect true taxable income. The contention was advanced that the government had no right to employ the net-worth approach in those cases where the taxpayer maintained records that presumably disclosed his income.[20] In many other cases the points at issue involved the adequacy of the "starting point," the specific aspects of the case to be proved by the government and the place where the defendant must take the initiative.

In 1954, the Supreme Court decided the *Holland* case[21] and three

[16] Gleckman v. United States, 80 F. 2d 394 (C.A. 8th, 1935), cert. denied 297 U.S. 709 (1936).

[17] 177 F. 2d 488 (C.A. 7th, 1949).

[18] 175 F. 2d 223 (C.A. 5th, 1949).

[19] United States v. Johnson, 319 U.S. 503 (1943).

[20] United States v. Williams, 208 F. 2d 457 (C.A. 3d, 1954).

[21] 348 U.S. 121 (1954).

[22] Friedberg v. United States, 348 U.S. 142 (1954); United States v. Calderon, 348 U.S. 160 (1954); Smith v. United States, 348 U.S. 147 (1954).

related cases[22] bearing upon net worth. The general use tof the net-worth method was approved, subject, however, to the employment of safeguards of the defendant's rights. In the *Holland* case, Mr. Justice Clark, in a definitely didactic manner, lays down the criteria to be followed in the development of this type of case. There is little question that his remarks are addressed not only to the lower courts but also to the personnel of the Treasury Department charged with the development of tax fraud cases.

The court sanctioned the use of the net-worth method even in those instances where the taxpayer had maintained records. It held that a provable opening net-worth must be established and evidence other than the taxpayer's testimony in this regard must be adduced. Within reason, the government must eliminate the possibility that non-income factors have produced the increase in net worth. Finally, an increase in net worth coupled with proof of a likely source of income will justify a finding by the jury that the net worth increases came from this source. It is emphasized by the court that the burden of proof is always that of the government, and that it devolves upon the trial court to see that instructions are given so that the jury is not overwhelmed by sheer arithmetic.

Since the *Holland* case and its qualified approval of the net-worth method, it may be expected that an even greater use of this means will be employed for the detection of the taxpayer who cannot be attacked by the specific-item method. Hence, unless such a taxpayer is willing merely to hoard the fruits of his evasion and to worship his money in the solitude of a vault, he may expect to be the subject of vigorous investigation the moment he applies his funds to the acquisition of ascertainable assets.

As can be readily imagined, the agents assigned to a tax fraud case are ordinarily well equipped by training and experience to undertake the investigation and to follow whichever method of attack that will lead to prosecution of the taxpayer and assessment of the additional tax and penalty. Ordinarily the taxpayer is not apprised that an investigation rather than an examination is under way, and it will not be until the passage of considerable time that he reaches the conclusion that the interest of the government in him is more than routine. In the interim the agents may have completed the unshakable foundations of an impregnable case.

It is to be questioned whether it is consistent with the traditions of

the American system that a criminal investigation be launched and that the taxpayer be approached for information and records without ever being formally advised of his constitutional rights not to incriminate himself. This, though, seems to be the practice, and if the taxpayer does surrender incriminating books and records and give information, he is deemed to have waived his rights even though never informed of them.[23]

Although the failure to advise a taxpayer of the pendency of a criminal investigation will not bar the use of the evidence that the taxpayer might validly have withheld, a different result may be reached in the situation in which the taxpayer is informed that no criminal action is contemplated and that the agents are merely concerned with a routine examination. In other words, if the taxpayer, in time-hallowed words, is lulled into a sense of false security by the actions and the representations of the agents, any evidence so obtained may be suppressed and, for all practical matters, the entire government case will become tainted by reason of the unfair tactics of the agents.

Probably the outstanding case in this connection is *In re Liebster*, a Pennsylvania District Court case.[24] In that case, the defendant, relying reasonably upon the belief that he was making a "voluntary disclosure" in accordance with the Treasury's then existent policy of granting immunity in such situations, furnished the agents with extremely damaging information. Subsequently, criminal proceedings were instituted and Liebster sought to suppress the evidence given by him. His petition to suppress was granted. While this case is found within the framework of rather unique circumstances, it may fairly be considered as authority for the proposition that evidence furnished or obtained upon the representation that it will not be used criminally should be suppressed.

Normally, at the inception of an investigation and during its course, the taxpayer's own records are the subject of close and repeated scrutiny. Whether or not, in the case of an individual taxpayer, to permit this scrutiny or to assert the taxpayer's constitutional rights, becomes a problem that is part of the general question of cooperation, that is, whether to assist the agents in their endeavors or to dare them to do their worst without his help.

[23] Nicola v. United States, 72 F. 2d 780 (C.A. 3d, 1934).

[24] 91 F. Supp. 814 (E.D. Pa., 1950).

It is not within the province of this article to decide the question, since in an actual case many factors must be weighed and an unqualified and unvarying recommendation for procedure cannot be made. As a practical matter, the damage often is done before the taxpayer has any realization of what is going on. The agents have gone through his books and records, have made the transcripts that they deem necessary, and have accumulated the "leads" which they intend to develop. Again, the business entity involved may be a corporate one, with the result that the individual involved cannot raise the question of constitutional immunity with respect to its records. Finally, the taxpayer may be unwilling to admit in any fashion that his records contain anything that may be wrong and therefore does not wish to make the tacit admission of guilt that may be involved by an assertion of constitutional rights.

Very often a taxpayer furnishes the basis for his conviction by his own records and his attempts at explanation. However, the government does not rest content with what it may obtain from the taxpayer. Every investigation is expanded to reach so far as possible every financial contact of the taxpayer, with the consequence that the *corpus delicti* will be made out by other than the taxpayer's uncorroborated admissions.

At all times the taxpayer may approach the agents to discuss the case. In fact, sooner or later he will be asked to give his formal "explanation" of what he has done and not done. At this juncture it is well to give thought as to what to do. It must never be forgotten that the investigating officers are seeking to make a case against the taxpayer if one can be made. They will not manufacture a case, of course, but they will view with the skepticism of long experience any explanation that is halting and unconvincing, let alone one that is obviously a tissue of fabrications. So, unless a taxpayer is willing to tell the truth and can afford to tell the truth, he may well consider the desirability of maintaining silence and avoiding the possibility of other difficulties arising from giving of a false statement.[25]

In its search for information the government leaves few stones unturned. This zeal for knowledge is not matched by any desire to impart information. Unless the investigation fails somewhere along the line, the defendant will not ordinarily know the full details of a case against him short of the time when a criminal trial begins. As a con-

[25] United States v. Beacon Brass Co., 344 U.S. 43 (1952).

sequence, the evaluation of the government's case prior to indictment will depend largely upon what the taxpayer recalls of his derelictions and what his representative can glean from his client (often not too much), from his own researches into the facts and circumstances, and from what his experience can furnish as to what the agents may have discovered.

As a rule contacts between the agents and the taxpayer's representative are fairly frequent during the course of the investigation. The agents are seeking additional information and the representative is seeking to overcome their case, although often his efforts are reminiscent of a man groping in the dark. The difficulty here encountered is met everywhere prior to indictment in that opposing the government's case inevitably involves the admission of certain facts that may be damaging and, to a large extent, the assumption of the burden of proof to establish the taxpayer's innocence.

Sooner or later, the investigation is concluded and the agent's report will be written, embodying the results of the inquiry. If the investigation has been negative as regards criminality, the special agent will normally disappear from the case and the revenue agent will take over alone. It may be that evidence of fraud was discovered but not in sufficient degree to warrant criminal prosecution. In that event the civil fraud penalty will be asserted but, aside from that feature, the case will progress fairly well in accordance with the procedure following routine examination, with some additional obstacles occasioned by the charge of fraud, if that extra element is present. The taxpayer will learn generally the nature of the adjustments involved and will have the opportunity to negotiate a settlement in conference with the officers of the Treasury Department. If he files a petition with the Tax Court and if the fraud penalty has been asserted, proof of fraud will be the burden of the government.

Reason exists to believe that there are times when an income tax investigation is *ex parte* and that the agents during the investigation tend to ignore the possibilities of innocence on the part of the taxpayer. No ground for complaint exists, however, with respect to what might be called the administrative "due process" that is available to the taxpayer. If the agents are deaf to what the taxpayer's representative deems to be irrefutable, he may present his arguments against prosecution in a conference with the local officials of the Intelligence Unit. Should he fail at this stage, he is given a further con-

ference with an attorney assigned to the Enforcement Division of the local Regional Counsel's office. This attorney has the responsibility of reviewing the report for prosecution and deciding whether it should go forward. If he can be convinced that the government does not have a criminal case, he will recommend against prosecution or, in the alternative, that additional investigation be undertaken to strengthen the case, a not too desirable consequence.

Should the attorney decide in favor of prosecution, the case is then forwarded for review by the Tax Division of the Department of Justice, in Washington. There it is closely scrutinized, and the taxpayer is again given the opportunity for a conference in which he may urge his points against prosecution. Needless to say, at any of these conferences vague generalities and self-serving declarations will not suffice. The taxpayer's arguments must be buttressed by proof and his failure to overcome the government's position will result in the case being forwarded to the appropriate United States' attorney for prosecution. The probability is that all of these conferences are matters of grace rather than of right and are of real advantage to the taxpayer who can afford to make a full disclosure in order to establish his innocence. For the taxpayer who cannot safely follow such a procedure, the most salutary consequence of discussing his case in conference is the decision that it is high time to prepare his criminal defense.

Once in the hands of the United States' attorney, the case becomes part of the grist of his mill. Presentation is made of the case to the grand jury and indictment is followed by trial. Whether the case is based upon specific items of evasion or upon net worth, the government has the burden of proof beyond a reasonable doubt. Because of the thorough investigations and the exhaustive reviews of the completed cases, the government secures an overwhelming majority of convictions, many by plea of guilty.

Following the conclusion of the criminal case and the disposition of the appeal, if any, the taxpayer will receive a notice of deficiency, the so-called 30-day letter. The amount claimed ordinarily will exceed that disclosed at the criminal trial, because of the reason that for purposes of prosecution the government ordinarily selects the more glaring and the more readily provable items of evasion.

With the receipt of the notice of deficiency, the taxpayer is again embarked upon another sea of troubles. If he has been found guilty

in a criminal trial or has pleaded guilty, that circumstance is urged against him. If prosecution did not ensue or if, *mirabile dictu*, he was acquitted following trial, the government may still allege civil fraud, even though the burden is upon it to establish by clear and convincing evidence that fraud existed. The disposition of the civil case entails conference after conference at one level or another of the Internal Revenue Service and it may well be that the taxpayer will file his petition in the Tax Court for a determination of the deficiency and the propriety of the fraud penalty. In the meantime interest has been running at six per cent, and when it is all over, the taxpayer is sadder, possibly wiser, and certainly more than slightly poorer.

The conclusion of all this is a moral to the effect that the way of the detected tax transgressor is hard and the fruits of tax evasion become ashes in his mouth. With succeeding years, the policy of the government has become increasingly severe and more, rather than fewer, prosecutions may be expected where any evidence of evasion exists. Whether such a policy of severity is desirable may well be debated. Temptation to evade is found in the progressively higher rates and will undoubtedly continue to beckon enticingly to those who find that sudden prosperity is more than overmatched by the exaction of taxes. No doubt there will always be those who will seek to evade no matter what the tax or punishment may be. On the other hand, there are others for whom punishment might well fall short of indictment and disgrace. Concededly, practical difficulties exist in drawing a line of demarcation, but an attempt in this direction might well serve the ends of justice, particularly when the heavy civil penalties are remembered.

Not too many years ago, administrative discretion did exist and all cases of criminality were not prosecuted. When a taxpayer could show with some degree of plausibility that standing trial would endanger life or health, prosecution was not recommended and the case was closed on the basis of tax and penalty. Abandonment of this policy by the government occurred early in 1953, with the result that today a moribund taxpayer could meet judge and jury only shortly before answering to a higher tribunal for his offenses. Actually, it is to be doubted that any judge would order a bedfast taxpayer to trial, and it is probably better that the decision as to the deferment or abandonment of prosecution on grounds of health be reached *sub judice*.

Also, prior to 1952, there existed the "voluntary disclosure" policy.

In effect, this provided that a taxpayer, prior to examination of his returns or the start of an investigation, might appear before the Treasury Department, beat his breast in contrition, and inform that agency of the nature, the extent and the details of his tax evasions, together with his willingness to atone in terms of paying up to the last cent for his wrongdoing. An investigation would thereupon be instituted and if it were found that the taxpayer had made a substantially correct disclosure, prosecution was not recommended and the taxpayer went his way after paying the deficiency in tax and the fraud penalty, together with the statutory interest.

Practical difficulties interfered with the sound administration of this plan, not the least of which were the conditions laid down by the government so that the taxpayer might avail himself of this opportunity to purge his guilt. The voluntary disclosure policy was rescinded in January, 1952, and from that time on a guilty taxpayer for six years must count anxiously the days since he was guilty of filing a fraudulent return on which the government may indict.

Abandonment of this policy is to be regretted in certain instances. From time to time a taxpayer, moved by grace or fear of punishment, seeks advice as to how he may make his peace and pay up what he owes to the Director of Internal Revenue. Absent the *locus penitentiae* previously afforded by the voluntary disclosure policy, he risks indictment by the filing of amended returns and presents a serious problem to whomever he turns for advice. If some measure of relief could be afforded in cases of this type, it definitely could be urged that little would be lost by the foregoing of criminal prosecution of a prodigal son who has returned to the fold of honest taxpayers.

Within the Internal Revenue Service itself, there is evidence of this tendency to deal severely with the erring taxpayer. "Scandals" involving Treasury personnel in recent years have been highlighted, and a very strong attempt has been made by the Internal Revenue service to supply the answer to the age-old question of, "*Quis custodiet ipsos custodes?*" The consequence is an inclination, based on prudence, to resolve doubtful cases against the taxpayer and to recommend for prosecution matters that in the past might have been considered suitable for settlement.

All things considered, the taxpayer who today is suspected of income tax evasion, may anticipate a period of storm and stress, of anxiety and uncertainty. To the extent that he has transgressed there is strong probability that he will be required to pay the penalty in terms

of liberty and money. To the degree that he has erred by negligence he may be required to make every effort to show the absence of intent as an element of his actions. In either event, he requires and should have capable representation. To outline, if only superficially, what may be expected in the course of this representation has been the purpose of this article.