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FRAUD CASES IN THE TAX COURT

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Tax evasion is considered most popular in the order of economic crimes of the twentieth century, for it is available to each of the 65 million taxpayers. Unlike bankruptcy and mail or stock fraud, tax evasion always carries with it allied civil sanctions providing for assessment and collection of taxes with severe penalties added. In referring to the civil penalties as remedial sanctions imposed in addition to the tax, the Supreme Court has said, "They are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud."[1] The fifty-per-cent fraud penalty provided by section 6653(b) of the Internal Revenue Code of 1954 is actually quasi-criminal in nature as the Government must prove the taxpayer's fraud.[2]

While a civil fraud case may result from criminal tax evasion, proof of that crime is not always the occasion for civil fraud action by the Internal Revenue Service. Many times, because of the different burden of proof and related factors, there is a successful assertion of the civil fraud penalty where there has been no criminal case prosecuted or where, in fact, a criminal prosecution by the Government has been unsuccessful. During the fiscal year ending June 30, 1962, there were 10,229 preliminary investigations for fraud by the IRS. Of these, 3,469 were full-scale investigations, out of which 1,341 resulted in recommendations of "no prosecution," and 2,128 resulted in recommendations for prosecution. Income tax fraud cases numbered 955 while the others were concerned with wagering, coin-operated gaming devices, and other miscellaneous Internal Revenue violations. During the fiscal year 1962 there were 7,681 indictments and informations obtained in the federal courts; 5,263 of these resulted in pleas of guilty or *nolo contendere*; 866 were tried and convicted while 402 were acquitted. The other 760 cases were dropped for various reasons.[3]

Origination of a Civil Tax Fraud Case

Every tax case, civil or criminal, starts at the audit level. In any examination where fraud is suspected, the examining revenue agent making the

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1. Helvering v. Mitchell, 303 U.S. 391, 401 (1938).

2. Int. Rev. Code of 1954, § 7454(a). The fact that the Government has the burden of proving fraud in a civil tax fraud case must be kept constantly in mind as this is the reverse of the situation in the ordinary civil tax case where the Commissioner's determination is presumed to be correct; it resembles a criminal tax case except that the burden is prescribed by the statute.

3. FY 1962 Comm'r of Int. Rev. Ann. Rep. 33.

audit will refer the case to a special agent of the Service's Intelligence Division. It is this special agent's task to determine whether or not the facts of the case warrant a recommendation for *criminal* prosecution. Either the special agent or the revenue agent, however, can recommend the assertion of a *civil* fraud penalty. Assuming no prosecution has been recommended at the conclusion of the audit, the revenue agent will notify the taxpayer of any asserted deficiencies and attempt to secure an agreement as to these deficiencies. If no agreement is secured, the taxpayer will usually be sent a "10-day letter" by the district director notifying him of the deficiency and the reasons therefor.[4] The taxpayer is given ten days from the date of the letter to request an informal conference with the Service to discuss the proposed adjustments with an impartial conference co-ordinator. The taxpayer is always entitled to be represented by an attorney or other duly qualified agent who is the holder of a treasury card entitling him to practice before the IRS.[5] If a representative is chosen, however, the taxpayer must execute a power of attorney giving his representative power to negotiate for him unless the taxpayer appears with his representative in person.[6] If the taxpayer wishes, upon receipt of the ten-day letter, he can execute form 870 and agree to the deficiency and penalties asserted against him. This precludes any appeal to the Tax Court.

If the informal conference is declined or no agreement is reached at the conference, a thirty-day letter will be issued by the Service. Along with the thirty-day letter the taxpayer will receive the revenue agent's examination report explaining the proposed adjustments. The taxpayer may then file a protest with the district director, which will enable his case to be referred to the Appellate Division of the Internal Revenue Service for further consideration. The protest is submitted within thirty days of the receipt of the district director's notice and should enumerate the items to which the taxpayer takes exception, together with the facts on which the taxpayer relies for his protest.[7] The hearings before the Appellate Division are informal, and no testimony is usually taken; however, the technical advisors who hear the case may request supporting data and documentation from the taxpayer to support his contentions. Briefs setting forth the law relied upon by the taxpayer are also considered by the Appellate Division.

If no agreement is reached in the Appellate Division, or if the taxpayer elects to waive the filing of a protest, a ninety-day letter, called a statutory notice of deficiency, will be issued.[8] Upon receipt of this notice, the taxpayer

4. 26 C.F.R. § 601.105(c) (1961).
5. 31 C.F.R. § 10.3 (1959) (requirements to practice).
6. 26 C.F.R. § 601.503 (1961).
7. 26 C.F.R. § 601.105 (1961).
8. INT. REV. CODE OF 1954, § 6212.

has four alternatives. (1) He can execute form 870 and pay the deficiency. (2) He can allow the ninety days to toll and pay the deficiency upon billing. (3) After payment, he can bring suit for refund in either a United States district court[9] or the United States Court of Claims. (4) He can file a petition with the Tax Court within the allotted ninety days.[10] This Article deals with the fourth alternative.

Once a case is within the jurisdiction of the Tax Court, settlement can only be obtained with the agreement of the Appellate Division and the regional counsel who represents the Commissioner.[11] Jurisdiction over the case for settlement purposes passes exclusively to the regional counsel on the calendar call in the session of the Tax Court.[12]

A taxpayer may be involuntarily required to pay over a deficiency and related penalties prior to the trial of the case in the Tax Court. This occurs where the district director believes that the assessment or collection of the deficiency will be jeopardized by delay, and he acts under the authority of section 6861 of the Internal Revenue Code of 1954. This section, however, requires that the notice of deficiency must be issued within sixty days of the jeopardy assessment. A taxpayer may stay collection by filing a bond with the district director in an amount at least equal to the deficiencies and penalties assessed in the notice of assessment.[13] After a jeopardy assessment, however, the Tax Court will retain jurisdiction to determine the proper amount of deficiency and penalties, if any.[14]

Section 6653(b) under which the civil fraud penalty is asserted provides, "That there shall be added to the tax an amount equal to 50% of the underpayment." "Underpayment" is the amount of the deficiency reflected from a comparison of the taxpayer's *original* return, if any was filed, with the statutory notice of deficiency.[15] This definition precludes the reduction of a penalty by filing an amended return prior to or after the statutory notice of deficiency.[16] Thus, a penalty may be asserted at the time of the issuance of the deficiency notice, although there is no tax due at that time.

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9. Although the district court offers a jury trial on factual issues, this is not always an advantage in a tax-fraud case because of the complexity of the issues; furthermore, many taxpayers forego any advantage the district court might afford because of the requirement that the deficiency be paid first. INT. REV. CODE OF 1954, § 6512(a). Thus, the Tax Court is the forum chosen in the great majority of civil fraud cases.

10. INT. REV. CODE OF 1954, § 6213.

11. 26 C.F.R. § 601.106 (1961).

12. 26 C.F.R. § 601.106 (1961).

13. INT. REV. CODE OF 1954, § 6863(a).

14. INT. REV. CODE OF 1954, § 6863(b)2.

15. INT. REV. CODE OF 1954, § 6653(c).

16. For cases under the Internal Revenue Code of 1939 to the same effect, see Middleton v. Commissioner, 200 F.2d 94 (5th Cir. 1952); Herbert Eck, 16 T.C. 511 (1951), *aff'd per curiam*, 202 F.2d 750 (2d Cir. 1953).

THE TAX COURT

The Tax Court is a forum of limited jurisdiction. It can only sit on matters related to income, estate, gift, and excess profits taxes, where a statutory notice of deficiency is mailed to the taxpayer and the taxpayer duly files a petition with it within the ninety-day period provided.[17] The Tax Court was formerly known as the Board of Tax Appeals and was organized under a 1924 act.[18] It was formed to serve as an independent forum in which a taxpayer could litigate deficiencies asserted against him without first having to pay them. Prior to the act of 1924, the only remedy the taxpayer had without paying the deficiency was an appeal to the Commissioner on Appeals and Reviews before his assessment. This was not an independent agency but was an integral part of the IRS. The Board of Tax Appeals satisfied the need for an independent forum. It was, and still is, an agency of the executive branch of the Government, and not part of the judicial structure.[19] Its functions are, however, formal and judicial in character, and all the rules of courtroom etiquette and evidence apply at its trials. One of the disadvantages under the 1924 act was that no direct appeal could be made from a decision of the Board of Tax Appeals to a court of appeals. If the taxpayer lost, the only remedy was a refund suit in a federal district court after the payment of the tax and penalties due. The 1926 act remedied this deficiency and provided for direct appeal to the circuit court of appeals or the District of Columbia Court of Appeals. In 1942 the Board of Tax Appeals was re-named the Tax Court of the United States.

The Tax Court is made up of sixteen judges with one acting as Chief Judge. All the judges are appointed by the President with the advice and consent of the Senate. They serve for a period of twelve years or less if they are appointed to complete an unexpired term.[20] The Tax Court's proceedings are conducted with the custom, dignity, and procedure of a court of law. One judge presides over each proceeding. The Tax Court provides its own rules of practice and procedure.[21] The rules of evidence applicable in trials without a jury in the United States District Court for the District of Columbia will apply in the Tax Court.[22] All evidence received by the Tax Court becomes public record. Its principal office is in Washington, D.C., but it may hear cases at any place within the United States where there are suitable accommodations available and where there is a sufficient number of

17. INT. REV. CODE OF 1954, § 6512. INT. REV. CODE OF 1954, § 7442 gives jurisdiction over excess profits taxes.
18. Revenue Act of 1924, Ch. 234, § 900, 43 Stat. 336.
19. INT. REV. CODE OF 1954, § 7441.
20. INT. REV. CODE OF 1954, § 7443.
21. INT. REV. CODE OF 1954, § 7453.
22. INT. REV. CODE OF 1954, § 7453.

cases ready for hearing.[23] The Tax Court provides a list of cities where the hearings are periodically held. Motions are generally heard in Washington on Wednesdays unless the taxpayer can show by motion good cause for holding the hearing elsewhere.[24]

The Internal Revenue Code of 1954 provides that no one duly qualified shall be denied the right to practice before the Tax Court;[25] however, attorneys and others must first apply for admission. Attorneys are admitted on motion while certified public accountants and others must take a written examination to qualify.

PLEADINGS

The filing by the taxpayer of a petition within ninety days of the receipt of the statutory notice of deficiency invokes the jurisdiction of the court.[26] Under the rules of the Tax Court a petition must contain a clear and concise statement of each and every error which the taxpayer alleges the Commissioner committed in determining the deficiency.[27] The taxpayer thereafter becomes the petitioner and the Commissioner becomes the respondent. Any affirmative defenses of the petitioner, such as the statute of limitations, should be pleaded in the petition.

The answer must be filed by the Commissioner within sixty days of the service of the petition.[28] Any motion made pertaining to the petition by the Commissioner must be filed within forty-five days of the service of the petition.[29] If he seeks the fraud penalty, the Commissioner must allege fraud as an affirmative allegation in his answer.[30] The answer should contain a specific admission or denial of each and every allegation of fact contained in the petition and a statement of the facts on which the Commissioner will rely in his defense of the affirmative allegations. The petitioner is thus on notice of the nature of the Commissioner's defense.

The petitioner must reply to the answer where there are affirmative allegations made by the Commissioner. Failure to do so results in petitioner's admission of the allegations.[31] The petitioner has forty-five days after service upon him of the answer in which to file a reply or thirty days within which to move with respect to the answer.[32] The reply, like the answer, should contain a specific admission or denial of each material allegation of fact

23. TAX CT. R. PRAC. 26.
24. TAX CT. R. PRAC. 27.
25. INT. REV. CODE OF 1954, § 7452.
26. INT. REV. CODE OF 1954, § 6512(a).
27. TAX CT. R. PRAC. 7.
28. TAX CT. R. PRAC. 14.
29. TAX CT. R. PRAC. 14.
30. TAX CT. R. PRAC. 14.
31. TAX CT. R. PRAC. 18.
32. TAX CT. R. PRAC. 15.

contained in the prior pleading, and it should in addition set forth any facts upon which the petitioner relies for a defense thereto.

The rules of the Tax Court provide that the petitioner may amend his petition any time before the answer without leave of court.[33] To amend after service of the answer, the petitioner must get the consent of the Commissioner or leave of the court by motion.[34] There is no specific rule as to amendments of the answer by the Commissioner, but the courts have held that the Commissioner may amend his answer at any time.[35]

Pre-Trial and Discovery Procedure

Discovery procedures are not employed as extensively in the litigation before the Tax Court as they are in other civil cases, because the facts are usually within the knowledge of the petitioner and because the Commissioner usually obtains his information before the Tax Court obtains jurisdiction. Certain devices are used, however. An important weapon in the hands of the petitioner in a fraud case is the motion for a further and better statement.[36] When the Commissioner makes a general allegation of fraud in his answer, the petitioner can make use of this motion to have the basis of the allegation of fraud explained so he can properly prepare his defense.

The rules of the Tax Court also provide for the taking of depositions upon oral examination[37] and upon written interrogatory.[38] Application for such depositions must be filed at least thirty days prior to the date set for the trial of the case.[39] Such depositions must be filed with the court at least ten days prior to the trial.[40] Depositions are often used where a witness will not be available to testify at the trial or where a witness is located far from the place of trial and the cost of his physical presence would be prohibitive. Under the rules of the court, depositions desired of witnesses in foreign countries must in most cases be taken by written interrogatory.[41] These interrogatories are forwarded directly to the court after they have been transcribed and sealed.

A new procedure effective June 1, 1963, is the rule 28 pre-trial conference.[42] Either party in a case on a trial calendar may move for a pre-trial conference, or the trial judge on his own motion may require a pre-trial

33. Tax Ct. R. Prac. 17.
34. Tax Ct. R. Prac. 17.
35. Henningsen v. Commissioner, 243 F.2d 954 (4th Cir. 1957); Helvering v. Edison Sec. Corp., 78 F.2d 85 (4th Cir. 1935); Saul Schlenoff, 13 CCH Tax Ct. Mem. 1057 (1954).
36. Tax Ct. R. Prac. 17(c).
37. Tax Ct. R. Prac. 45.
38. Tax Ct. R. Prac. 46.
39. Tax Ct. R. Prac. 45(b).
40. Tax Ct. R. Prac. 45(b).
41. Tax Ct. R. Prac. 46(d).
42. Tax Ct. R. Prac. 28.

conference. Also, prior to the listing of a case for trial, the Chief Judge, upon his own motion or that of either party, may place the case upon the next calendar in the taxpayer's city for a pre-trial conference. Pre-trial conferences will be held where there is a possibility of narrowing the issues, stipulating the facts, simplifying the presentation of evidence, or otherwise assisting in the preparation for trial or other disposition of the case without the necessity of a trial on all the issues. A request for pre-trial conference may be made orally at the calendar call or by written motion with the Tax Court in Washington, and should include a statement of the reason for the request.

The rules of the Tax Court state that the pre-trial conference will not be held as a substitute for the conferences required between the parties to enable a stipulation of facts to be presented to the court. Under the rules of the Tax Court the parties, prior to the trial, are required to get together in order to enter into a stipulation of facts. The rules provide that "The Court expects the parties to stipulate evidence to the fullest extent to which complete or qualified agreement can be reached including all material facts that are not or fairly should not be in dispute."[43] A penalty is provided if a party fails to confer with his adversary in order to stipulate the facts which are not in dispute.[44]

Before trial, Service procedure dictates that the Appellate Division shall make a final effort to dispose of the case by settlement. This can be accomplished by means of the pre-trial conference.[45] (This conference should not be confused with the pretrial conference called for under rule 28 of the Tax Court Rules of Practice.) Across the conference table respondent's and petitioner's counsel can together assess the merits of their respective causes. The technical advisor of the Appellate Division staff, because of his greater experience at this time with the case file, generally conducts the conference. The special attorney of the regional counsel's staff has previously had a hand in the preparation of the statutory notice of deficiency, and he here acts to enforce the deficiency claim for the Appellate Division. If no settlement appears likely at this conference, a general discussion as to trial problems and stipulation possibilities will usually occur between counsel. If a settlement is likely, further conferences will explore its possibilities.

About six months prior to trial, the court issues a trial status request to both respondent and petitioner. Such request indicates a proposed session date and seeks the advice of the parties as to their readiness, estimated time of

43. TAX CT. R. PRAC. 31(b)(1).

44. TAX CT. R. PRAC. 31(b)(1). Upon motion of the opposing party, facts and evidence in possession of a dilatory party may be considered established for purposes of the case.

45. Rev. Proc. 60-18, 1960-2 CUM. BULL. 988. This ruling outlines conference procedure, which should in all cases be consulted by petitioner's counsel prior to the pre-trial conference.

trial, and possibility of settlement. This advice enables the clerk of the court to prepare the calendars well in advance of the trial. Notice that their case has been set for trial is sent to the parties at least ninety days prior to the session of the court.[46] During this last ninety-day period, as the parties prepare their cases, pressure develops for further stipulation of facts. It is also at this time, when trial is imminent, that a final evaluation—more often than not—produces settlement. Under current procedures, however, settlement at this stage is becoming increasingly unlikely, and the wise practitioner will not wait this long to propose a settlement.

The Trial

Calendar call usually fills the courtroom with counsel for petitioners and respondent, and as each case is called the judge will request an estimate by the parties as to the time required to try their case. The respondent in fraud cases has the burden of proving the fraud and will usually require more time than the petitioner. Frequently, many witnesses are present, appearing under subpoenas which are ordinarily dated for the calendar call.

The court on this day is invariably presented with requests for continuances, which are almost always opposed by the respondent (although on occasion he is the moving party). Such continuances are, however, granted reluctantly and only for good cause. Conflicting engagements or employment of new counsel is not regarded as "good cause."

Upon the call of the case, opening statements by both parties setting forth the facts they intend to prove and the law upon which they will rely are heard. Although normally the petitioner presents his evidence first, in fraud cases it is not unusual for the Commissioner to present his case first. The determining factor is, which party has the burden of proof. The Tax Court Rules of Practice state, "The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent."[47] By statute where the issue is whether or not the petitioner is guilty of fraud with intent to evade taxes, the burden of proof is upon the Commissioner of Internal Revenue.[48] This provision does not always govern who will present his case first, however, because the burden as to proving the deficiency erroneous is on the petitioner even where a fraud penalty is asserted.[49]

The statute of limitations plays an important part in determining which party has the burden of proving or disproving an alleged deficiency. The

46. Tax Ct. R. Prac. 27(b)(1).
47. Tax Ct. R. Prac. 32.
48. Int. Rev. Code of 1954, § 7454(a).
49. Int. Rev. Code of 1954, § 7422(e).

time within which deficiencies must be assessed is three years from the last day the return is due,[50] but the period is extended to six years where the Commissioner can prove that the taxpayer understated his gross income by twenty-five per cent or more for the year in question.[51] Where the Commissioner can prove a fraudulent evasion of income tax by a taxpayer there is no statute of limitations as to assessments of deficiencies.[52] Thus, if the Commissioner asserts a deficiency for any year that would be foreclosed by the three-year statute of limitations, he has the burden of proving the six-year statute of limitations applies[53] or, where he asserts fraud, that there is no limitation for time of assessment.[54] In such cases the Commissioner is required to present his evidence first, because if the Commissioner does not carry his burden on this point by "clear and convincing evidence,"[55] there will be no issue as to the deficiency itself. Where some of the deficiencies assessed are restricted by the three-year statute of limitations and others are not, it is within the judge's discretion to determine whether petitioner or respondent will first present evidence.[56]

To sustain the burden of proof as to fraud, the Commissioner must prove that there was an underpayment of tax according to the Internal Revenue Code[57] and that some part of this underpayment was due to wilful, fraudulent evasion.[58] A deficiency paid by filing an amended return after the due date may still be considered an underpayment for purposes of assessment of a fraud penalty.[59] The issue of whether or not a taxpayer is "guilty of fraud with intent to evade taxes" is primarily a question of fact.[60] The Tax Court examines all of the facts presented by both sides in determining this issue.

The Commissioner must prove fraud by "clear and convincing evidence."[61] This is less than the standard of "beyond a reasonable doubt" required in a criminal tax evasion case,[62] but more than the normal burden in civil cases of proof by a preponderance of the evidence. The Commissioner's burden has

50. INT. REV. CODE OF 1954, § 6501(a).
51. INT. REV. CODE OF 1954, § 6501(e).
52. INT. REV. CODE OF 1954, § 6501(c).
53. INT. REV. CODE OF 1954, § 7422(e).
54. INT. REV. CODE OF 1954, § 7454(a).
55. Klassie v. United States, 289 F.2d 96, 101 (1961).
56. *Id.* at 100.
57. INT. REV. CODE OF 1954, § 6653(c).
58. INT. REV. CODE OF 1954, § 6653(b).
59. See Middleton v. Commissioner, 200 F.2d 94 (5th Cir. 1952); Herbert Eck, 16 T.C. 517 (1951), *aff'd per curiam*, 202 F.2d 750 (2d Cir. 1953).
60. Klassie v. United States, 289 F.2d 96, 101 (1961).
61. See United States v. Thompson, 279 F.2d 165 (10th Cir. 1960); Rea M. Gano, 19 B.T.A. 518 (1930).
62. See Holland v. United States, 348 U.S. 121 (1954).

been set forth time and again in the opinions of the Tax Court and in those of higher courts.[63] Judge Drennen of the Tax Court recently held,

> A charge of fraud has always been regarded as a serious matter in the law. Not only is it never presumed, but the ordinary preponderance of evidence is not sufficient to establish such a charge. It must be proved by clear and convincing evidence.[64]

The Commissioner assumes a most difficult burden in proving fraudulent evasion of tax. Generally it is difficult to prove evasion by a single act; hence, the court must examine all of the taxpayer's acts. The process was described by the Tax Court as follows:

> [I]nvolving as it does the personal intent of the taxpayer and intent being a state of mind, seldom can one act be singled out and pointed to as evidencing such fraudulent intent. Rather, it is usually found by surveying the whole course of conduct of the taxpayer. Thus, whether a fraudulent intention is held by a taxpayer at a given time is a fact to be gleaned, as any other fact, from all the evidence of record and inferences properly to be drawn therefrom.[65]

It can be readily seen why a decision based on the record as a whole, finding as a fact fraudulent intent on the part of the taxpayer, is extremely difficult to reverse in a court of appeals. The Supreme Court in *Holland v. United States*,[66] a criminal tax evasion case, held that an inference of wilfulness can be supported where there is "evidence of a consistent pattern of under-reporting large amounts of income and of the failure on petitioners' part to include all of their income in their books and records."[67] The finding of a consistent pattern of under-reporting large amounts of income has since been used by the Tax Court many times to find fraudulent intent.[68]

In *Holland* the Supreme Court evaluated the "net-worth" method, one of the methods used by the IRS to find large amounts of unreported income. The Supreme Court indicated the net-worth method is so wrought with danger for the innocent that its use must be continually scrutinized. Contrary to the "specific omission" case, where items omitted from taxable income are directly pinpointed, the net-worth case employs circumstantial evidence.[69] The dangers inherent in the use of this method of ascertaining taxable income

63. *E.g.*, Powell v. Grandquist, 252 F.2d 56 (9th Cir. 1958); Rea M. Gano, 19 B.T.A. 518 (1930); Mark A. Bird, 21 CCH Tax Ct. Mem. 384 (1962); Benjamin Kann, 20 CCH Tax Ct. Mem. 1526 (1961).

64. *Id.* at 1529.

65. Sam Goldberg, 13 CCH Tax Ct. Mem. 1207, 1300 (1954).

66. 348 U.S. 121 (1954).

67. *Id.* at 139.

68. *E.g.*, Nathan Bilsky, 31 T.C. 35, 43 (1958); David H. Schultz, 30 T.C. 256, 276 (1958).

69. See Holland v. United States, 348 U.S. 121 (1954).

become apparent with a discussion of its operation. After the Government concludes that the taxpayer's records are inadequate for purposes of reporting taxable income, it establishes the taxpayer's net worth, or total value of assets at the beginning of a given year. This procedure is repeated for each succeeding year in issue. The taxpayer's nondeductible expenditures, as ascertained by the revenue agent or special agent, including living expenses, are added to the net-worth increases for each year. If the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer, the Commissioner may claim the excess represents unreported taxable income. The Commissioner adds to the deficiency the fifty-per-cent fraud penalty. The basic assumption in such a case is that the assets are derived from taxable sources. This method first appeared in cases involving known criminals where all other efforts to ascertain income failed. Two of the most celebrated cases using the net-worth method were *Capone v. United States*[70] and *United States v. Johnson*.[71] The Commissioner often uses this method today in routine cases even though the Supreme Court has questioned its use in such cases saying, "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 chances for error."[72]

The taxpayer's defense in net-worth cases is usually the "cash hoard," or a buildup of large sums of cash kept hidden for various reasons and not expended until the period in question. The taxpayer usually establishes when the hoard was accumulated. It is normal for the alleged hoard to have been built up over many years which makes the hoarding difficult to prove or disprove. Nontaxable sources of such hoarded cash may be, for example, gifts, inheritances, or loans.[73] As the burden to prove fraud is on the respondent, he must prove the buildup in net worth and negate the explanation of the taxpayer as to alleged nontaxable sources of cash.[74]

The respondent must also prove a likely source of the net-worth increases. If the taxpayer is in a business and if the income shown by the books and records is a fraction of what the business is shown to be capable of earning, the respondent's burden will be more easily met. In determining wilfulness in a criminal tax evasion case, the Supreme Court has said that when no books and records are kept, evasion may be inferred from that fact

70. 51 F.2d 609 (7th Cir. 1931).
71. 319 U.S. 503 (1943).
72. Holland v. United States, 348 U.S. 121, 126 (1954).
73. *Id.* at 127.
74. "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." *Id.* at 135.

coupled with the understatement of income.[75] Where books and records appear correct on their face, however, such an inference from the net-worth increases alone may be unjustified, assuming the circumstances surrounding the deficiency are as consistent with innocent mistake as with wilful violation of the tax laws. The use of the net-worth method is an area where innocent taxpayers can fall prey to the fraud penalty and where the Commissioner must be especially careful in the assertion of such penalty.

In the *Holland* case the taxpayer asked the Court to restrict the net-worth method to situations where the taxpayer has kept no books. The basis for the argument was that the Internal Revenue Code states that net income should be computed in accordance with the methods of accounting regularly employed in keeping the books of the taxpayer or, if such method does not clearly reflect income, under a method that in the opinion of the Commissioner does so.[76] The Supreme Court said that the provision refers to methods such as cash receipts or accrual and that the net-worth method is not a method of accounting. It held, "Certainly Congress never intended to make § 41 a set of blinders which prevents the Government from looking beyond the self-serving declarations in a taxpayer's books."[77] Thus, the Supreme Court approved of the Commissioner's use of the net-worth method although the taxpayer keeps books but not without certain admonitions about the danger of its improper use.[78]

In net-worth cases, once the respondent has met his burden of proof by negating possible nontaxable sources and proving a probable tax source, the burden of disproving the assessment should fall upon the petitioner. Assuming there was a buildup in net worth over the years, the petitioner would have to prove where and how it occurred. In many cases the buildup has been kept well hidden by the petitioner, which limits the number of his witnesses. The issue in most net-worth cases turns upon the credibility of the petitioner as evidenced by his demeanor on the witness stand.[79]

The use of unexplained bank deposits is another major method utilized by the Commissioner where books and records fail.[80] The bank deposit method is based upon the assumption that large amounts of money deposited in a given year which are over and above the amount of taxable income reported are derived from taxable sources. As in net-worth cases, unless the

75. *Id.* at 130.
76. INT. REV. CODE OF 1954, § 446.
77. Holland v. United States, 348 U.S. 121, 132 (1954).
78. "While sound administration of the criminal law requires that the net worth approach—a powerful method of proving otherwise undetectable offenses—should not be denied the Government, its failure to investigate leads furnished by the taxpayer might result in serious injustice." *Id.* at 135.
79. Bessie Brouse Nelson, 20 CCH Tax Ct. Mem. 1100 (1961).
80. *E.g.*, A. W. Minyard, 16 P-H Tax Ct. Mem. 951 (1947).

Commissioner alleges fraud, the burden of disproving that the source of the deposit is taxable will be entirely on the petitioner.[81] Clear proof by the Commissioner is required as to the taxable sources of the money in order to sustain the fraud penalty. The Tax Court has held, "A mere showing that currency deposited in the bank came from a safe-deposit box is not of itself proof that the money was subject to taxation in the year during which it was deposited."[82]

The principal point of litigation with this method, as well as with the net-worth method, is the possible nontaxable sources of the money. Where the taxpayer can establish that substantial deposits came from nontaxable sources, the Commissioner will not succeed with the unexplained-bank-deposits method.[83] As in net-worth cases, it is more difficult in this case for the Commissioner to use the bank deposit method where the taxpayer keeps books that appear to adequately reflect the taxpayer's income.

The death of the taxpayer prior to the trial of a civil fraud case has no legal effect on the assertion of the fraud penalty because the penalty is compensatory, not punitive.[84] Under a special ruling issued August 24, 1945, the Commissioner may, however, depending on the facts and circumstances of the case, decline to enforce the fraud penalty.[85] If the Commissioner wishes to proceed with the action, the estate is liable for any deficiency plus penalties.[86] In *Benjamin Kann*,[87] petitioner died prior to the trial, and no one represented the estate at the trial. The Commissioner then moved that the case be dismissed for lack of prosecution with respect to the deficiencies and that the court enter a decision for the Commissioner. The court denied the motion, stating that it was not divested of jurisdiction even though the petitioner had died, and no personal representative had been appointed for the estate, as the petition and reply to the Commissioner's answer were duly filed.[88] The reply denied the allegations of fraud and pleaded the statute of limitations. Thus, the Commissioner was put to his burden of proof.[89]

81. *Id.* at 955. In both net-worth and bank deposit cases, it must be remembered, however, that where the years in question are not "closed" by the three-year statute of limitations, the burden of disproving the deficiencies will be squarely on the petitioner even if the Commissioner does allege fraud but does not succeed in his burden as to the fraud penalty. *Id.* at 959.

82. *Id.* at 960. This situation would be particularly true where the safe-deposit box had been in use for a long period of time.

83. Murray Glackman, 10 CCH Tax Ct. Mem. 1132 (1951); Pearl H. Jackson, 7 CCH Tax Ct. Mem. 507 (1948).

84. See Helvering v. Mitchell, 303 U.S. 391 (1938).

85. 4 CCH 1945 STAND. FED. TAX REP. ¶ 6300.

86. A. Diamond, 19 CCH Tax Ct. Mem. 1477 (1960).

87. 20 CCH Tax Ct. Mem. 1526 (1961).

88. *Id.* at 1528.

After the Commissioner had submitted his evidence the court held that he had not sustained the burden and decided for the deceased petitioner.

Many times in the trial of a civil fraud case, a question arises as to the effect of a prior criminal tax-evasion prosecution against the same taxpayer for the same years. The Supreme Court in *Helvering v. Mitchell*[90] held that where a taxpayer was acquitted in a criminal action for attempting to evade taxes the Commissioner was not barred from asserting the fraud penalty in a civil action. The petitioner asserted collateral estoppel and double jeopardy, but both arguments were dismissed by the Court.[91] In regard to collateral estoppel the Court held that the difference in the degrees of proof in criminal and civil cases precludes the application of the doctrine of res judicata, as the burden in the criminal cases is beyond a reasonable doubt and in civil tax fraud cases, clear and convincing proof.[92]

The rationale of the Supreme Court in *Mitchell* has been applied by the Tax Court to situations where the taxpayer was convicted of criminal tax evasion and subsequently the Commissioner asserted that the taxpayer was collaterally estopped from defending against the fraud penalty in the Tax Court. In *Meyer J. Safra,*[93] the Tax Court cited *Mitchell* and held that if the petitioner were to be estopped from litigating the civil fraud penalty after being convicted for the criminal fraud penalty it would be inconsistent with the holding of the Supreme Court. This appears to be a liberal view of the Supreme Court's holding, but it has been followed in other cases by the Tax Court.[94] In a later case, Chief Judge Tietjens wrote,

> We have held that the fact of the trial and conviction of a petitioner is not to be deemed conclusive in a civil suit arising out of the same matter but is evidence to be given weight according to the circumstances.[95]

Even though a conviction after trial for criminal tax evasion cannot of itself sustain the burden of proof for the Commissioner in a civil fraud case, it has been held that a plea of guilty in a criminal tax-evasion case without

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89. *Id.* at 1528. When petitioner does not appear at his own trial, the Commissioner must still sustain his burden of proof where fraud is asserted; however, a presumption may arise in favor of the Commissioner as the result of the failure of the petitioner to testify in his own behalf. *Ibid.*

90. 303 U.S. 391 (1938).

91. Helvering v. Mitchell, 303 U.S. at 401-05.

92. *Ibid.*

93. 30 T.C. 1028 (1958).

94. Clarence Wood, 37 T.C. 70, 78 (1961); Rudolf A. Zivnuska, 33 T.C. 220, 240 (1961).

95. Homer L. Blackwell, 20 CCH Tax Ct. Mem. 599, 618 (1961).

further explanation is sufficient to establish civil fraud.[96] Such pleas are admissions against interest and without further explanation as to the circumstances surrounding them are sufficient to establish fraud with intent to evade tax.[97]

In civil fraud cases, the failure of the taxpayer to testify on his own behalf will raise a presumption that the facts he might have testified to would have been resolved against him;[98] this is unlike a criminal fraud case where no presumption arises if the taxpayer does not wish to testify. There are times in Tax Court proceedings where the taxpayer may refuse to testify on the strength of his constitutional privilege against self-incrimination.[99] To invoke the privilege there must be a possibility of future criminal prosecution in connection with the testimony he is asked to give.[100] This failure to testify, however, will not help his cause. If the taxpayer has previously been prosecuted for criminal tax evasion, he cannot refuse to testify in a civil fraud case where the testimony involves facts which would tend to prove him guilty of criminal tax evasion for the year for which he was already prosecuted.[101] Where the taxpayer testifies as to matters in his own behalf on direct examination, the Supreme Court has held that his privilege is waived on cross-examination as to matters he made relevant on direct examination.[102] Taxpayer's counsel should thus be careful not to open up any doors to incriminating evidence on direct examination.

In a fraud case Government agents are frequently important witnesses. Their direct testimony will disclose the results of their exhaustive investigations, and their vast findings are generally reduced to schedules and, as such, are introduced into evidence. It is good practice (often mandatory) that the services of an accountant be obtained by petitioner's counsel during the examination of the Government agents. When voluminous schedules are put into evidence by the agents, it is always important to have an immediate professional evaluation of their relevance and effect on the issues of the case.

Often in fraud cases problems arise in areas covered by the "best evidence" rule. These problems are usually solvable prior to trial by effective stipulation of the parties. Stipulation as to the problems also assists counsel in the preparation of their cases, because it enables them to examine documents

96. Marcus Siegal, 15 CCH Tax Ct. Mem. 129 (1956).
97. *Ibid.*
98. Max Cohen, 9 T.C. 1156 (1947), *aff'd*, 176 F.2d 394 (10th Cir. 1949).
99. Brown v. United States, 356 U.S. 148 (1958). The privilege against self-incrimination applies to civil as well as criminal proceedings.
100. United States v. Molasky, 118 F.2d 128 (7th Cir. 1941).
101. If no other years are involved in a civil fraud case than the years the taxpayer was convicted for criminal fraud, there is no possibility that a taxpayer will incriminate himself because he cannot be tried twice for the same offense.
102. Brown v. United States, 356 U.S. 148 (1957).

at the pre-trial stage which are otherwise not seen until their introduction. Pursuant to the rules of the Tax Court, the rules of evidence applicable in trials without a jury in the United States District Court for the District of Columbia apply in the Tax Court.[103] Thus, counsel should not be lulled into thinking, as the result of the informal conferences held before the trial, that the trial will be an informal proceeding. It is an adversary proceeding in every sense and counsel should be fully prepared.

After both parties have rested their case, the court will set a date for the filing of briefs. The Tax Court brief is in effect an argument and summation enabling full comment on cogent evidence by respective counsel. Dates for briefs are usually set from thirty to sixty days hence, and it is good practice to request the maximum time that may be needed rather than to apply for leave to file late.

Decision and Appeal

In cases where the issues are for the most part factual in nature, the judge sitting at the trial will decide the case, and the decision will be deemed a memorandum decision.[104] Cases involving important questions of law will be passed on by all of the Tax Court judges. The Chief Judge may decide the case is appropriate for such treatment, or the judge who originally heard the case may request it.[105] Upon decision tax computations are made and entered under rule 50.[106]

Petition for review by a United States court of appeals must be filed within three months after the decision of the Tax Court is rendered[107] or that decision becomes final.[108] The court of appeals where the district director's office to which the tax return in issue was filed has jurisdiction, or if no return was filed, the Court of Appeals for the District of Columbia has jurisdiction.[109] The taxpayer and counsel for the Government may, however, stipulate to the jurisdiction of any other court of appeals.[110] Under the Judicial Code the courts of appeals are authorized to review Tax Court decisions as they would review decisions of the district courts in actions tried without a jury.[111] Thus, findings of fact as well as findings of law are subject to appellate review.[112] Between the time of the decision of the Tax

103. Tax Ct. R. Prac. 31.
104. Such decisions are not reported officially by the Tax Court but are published privately.
105. These opinions are officially reported by the Government in the *Tax Court of the United States Reports;* the dissenting opinions of the judges may be included.
106. Tax Ct. R. Prac. 50.
107. Int. Rev. Code of 1954, § 7483.
108. Int. Rev. Code of 1954, § 7481.
109. Int. Rev. Code of 1954, § 7482(b).
110. Int. Rev. Code of 1954, § 7482(b).
111. Int. Rev. Code of 1954, § 7482(a).
112. Int. Rev. Code of 1954, § 7482.

Court and the outcome of an appeal, the Commissioner may assess any deficiency found by the Tax Court. The taxpayer may stay the collection, however, by filing with the Tax Court a bond guaranteeing the payment of the deficiency.[113] On review, the court of appeals can reverse the finding of fact if it finds that the Tax Court was "clearly erroneous" in its findings or that its findings were based on a substantial error of law.[114] Notwithstanding that the Tax Court is a part of the executive branch, it has been held that a decision of the Tax Court has the same status as the decision of a federal district court.[115]

Within ninety days after the entry of judgment by a court of appeals, a writ of certiorari to the Supreme Court may be applied for.[116] The denial of a petition for certiorari means that at least four judges did not believe the matter in issue should come before the Supreme Court at that particular time. Such a denial has no precedent value whatsoever. Once certiorari to the Supreme Court is denied, the decision will become final.

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113. INT. REV. CODE OF 1954, § 7485.

114. Wisconsin Memorial Park Co. v. Commissioner, 255 F.2d 751 (7th Cir. 1958); Gillette's Estate v. Commissioner, 182 F.2d 1010 (9th Cir. 1950).

115. Wisconsin Memorial Park Co. v. Commissioner, *supra* note 114.

116. 28 U.S.C. § 2101(c) (1958).