31.00 NET WORTH

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31.01 **GENERALLY**

The net worth method of proof is a long-established indirect method of proof regularly used in establishing taxable income in criminal tax cases. This method of proof is useful in reconstructing taxable income when the government is unable to establish income through direct evidence. *See*, *e.g.*, *United States v. Johnson*, 319 U.S. 503, 517 (1943), involving gambling transactions where all records had been destroyed. The net worth method produces an approximation. *Holland v. United States*, 348 U.S. 121, 129 (1954); *United States v. Giacalone*, 574 F.2d 328, 332 (6th Cir. 1978). *See also United States v. Gomez- Soto*, 723 F.2d 649, 655 (9th Cir. 1983); *United States v. Schafer*, 580 F.2d 774, 777 (5th Cir. 1978). This method operates on the concept that if a taxpayer has more wealth at the end of a given year than at the beginning of that year, and the increase does not result from nontaxable sources such as gifts, loans, and inheritances, then the increase is a measure of taxable income for that year. Because nondeductible expenditures are added to any net worth increase, the method is sometimes referred to as the net worth and expenditures method.

It is important when constructing a net worth computation to include only items or transactions which reflect tax consequences. For this reason, nontaxable items received during a prosecution year must be eliminated from the computation of additional taxable income under the net worth method.

A net worth computation reveals not only that the defendant had income but how that income was spent. In essence, the computation depicts the financial life of a taxpayer, both prior to and during the prosecution period. *Holland*, 348 U.S. at 132; *United States v. Mastropieri*, 685 F.2d 776, 778 (2d Cir.1982).

Although endorsing the net worth method, the Supreme Court has cautioned that "it is so fraught with danger for the innocent that the courts must closely scrutinize its use." *Holland*, 348 U.S. at 125. Despite the possible pitfalls inherent in the method, the Supreme Court has approved its use a number of times. *See*, *e.g.*, *Massei v. United States*, 355 U.S. 595 (1958); *United States v. Calderon*, 348 U.S. 160 (1954); *Smith v. United States*, 348 U.S. 147 (1954); *Friedberg v. United States*, 348 U.S. 142 (1954); *Holland*, 348 U.S. 121; *Johnson*, 319 U.S. 503.

For an example of a net worth computation, *see* Section 31.16, *infra*.

31.02 **DESCRIPTION OF NET WORTH METHOD**

The First Circuit described the net worth method as follows:

> The Government makes out a prima facie case under the net worth method of proof if it establishes the defendant's opening net worth (computed as assets at cost basis less liabilities) with reasonable certainty and then shows increases in his net worth for each year in question which, added to his nondeductible expenditures and excluding his known nontaxable receipts for the year, exceed his reported taxable income

> by a substantial amount. The jury may infer that the defendant's excess net worth increases represent unreported taxable income if the Government either shows a likely source, or negates all possible nontaxable sources.
>
> [T]he jury may further infer willfulness from the fact of underreporting coupled with evidence of conduct by the defendant tending to mislead or conceal.

United States v. Sorrentino, 726 F.2d 876, 879-80 (1st Cir. 1984) (citations omitted). *See also Holland v. United States*, 348 U.S. 121, 125 (1954); *United States v. Terrell*, 754 F.2d 1139, 1144 (5th Cir. 1985); *United States v. Wirsing*, 719 F.2d 859, 871 (6th Cir. 1983); *United States v. Greene*, 698 F.2d 1364, 1370 (9th Cir. 1983); *United States v. Goldstein*, 685 F.2d 179, 182 (7th Cir. 1982); *United States v. Goichman*, 547 F.2d 778, 781 (3d Cir. 1976); *United States v. O'Connor*, 273 F.2d 358, 361 (2d Cir. 1959).

The Fifth Circuit summarized the steps necessary to establish income when applying the net worth method of proof:

> The government established its case through the "net worth" approach, a method of circumstantial proof which basically consists of five steps: (1) calculation of net worth at the end of a taxable year, (2) subtraction of net worth at the beginning of the same taxable year, (3) addition of non-deductible expenditures for personal, including living, expenditures, (4) subtraction of receipts from income sources that are non-taxable, and (5) comparison of the resultant figure with the amount of taxable income reported by the taxpayer to determine the amount, if any, of underreporting.

United States v. Schafer, 580 F.2d 774, 775 (5th Cir. 1978).

31.03 **USE OF NET WORTH METHOD**

31.03[1] **Inadequate Books and Records**

The net worth method of proof frequently is used when it would be difficult or impossible to establish the defendant's taxable income by direct evidence. *United States v. Dwoskin*, 644 F.2d 418, 423 (5th Cir. 1981); Often, the defendant's books and records are inadequate, false, or not available to the government. *See, e.g., United States v. Shetty*, 130 F.3d 1324 (9th Cir. 1997); *United States v. Notch*, 939 F.2d 895, 897-98 (10th Cir. 1991); *United States v. Stone*, 531 F.2d 939, 940 n.1 (8th Cir.1976); *United States v. Hom Ming Dong*, 436 F.2d 1237, 1240 (9th Cir. 1971). Although a defendant's books and records can be helpful, they are not essential. "[I]n a typical net worth prosecution, the Government, having concluded that the taxpayer's records are inadequate as a basis for determining income tax liability," seeks to establish taxable income by the net worth method. *United States v. Schafer*, 580 F.2d 774, 775 (5th Cir.1978). *See also Holland v. United States*, 348 U.S. 121, 125 (1954); *accord United States v. Terrell*, 754 F.2d 1139, 1144 (5th Cir. 1985).

Similarly, the net worth method can be used when the defendant has no books and records. In such a case, "willfulness may be inferred by the jury from that fact coupled with proof of an understatement of income." *Holland*, 348 U.S. at 128. *See also Campodonico v. United States*, 222 F.2d 310, 313 (9th Cir. 1955).

31.03[2] **Adequate Books and Records**

Although early cases held that the government could not use the net worth method in situations in which the defendant had "adequate" books and

records, the Supreme Court rejected this view in 1954, stating:

> The net worth technique, as used in this case, is not a method of accounting different from the one employed by defendants. It is not a method of accounting at all, except insofar as it calls upon taxpayers to account for their unexplained income. Petitioners' accounting system was appropriate for their business purposes; and admittedly, the Government did not detect any specific false entries therein. Nevertheless, if we believe the Government's evidence, as the jury did, we must conclude that the defendants' books were more consistent than truthful, and that many items of income had disappeared before they had ever reached the recording stage. . . . To protect the revenue from those who do not `render true accounts,' the Government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history.

Holland v. United States, 348 U.S. 121, 131-32 (1954). Thus, the state of the defendant's records has no bearing on whether the net worth method of proof may be used.

In the wake of *Holland*, the Fifth Circuit rejected a defendant's claim that the government's use of the net worth method of proof was improper because the government did not make a preliminary showing regarding the state of the defendant's records. *McGrew v. United States*, 222 F.2d 458, 459 (5th Cir. 1955); [FN1] *accord United States v. Vanderburgh*, 473 F.2d 1313, 1314 (9th Cir. 1973) (government may use the net worth method of proof even where the defendant contends that he maintained an allegedly complete and adequate set of books of account); *United States v. De Lucia*, 262 F.2d 610, 614 (7th Cir. 1958).

31.03[3] **Use With Other Methods**

The government is not limited to a single method of proof and may use the net worth method in conjunction with other methods of proof. *See*, *e.g.*, *United States v. Abodeely*, 801 F.2d 1020, 1023 (8th Cir. 1986). In *Abodeely*, a tax evasion prosecution in which the defendant received unreported income from gambling and prostitution, the Eighth Circuit discussed the net worth, cash expenditures, and bank deposits methods of proof:

> The government may choose to proceed under any single theory of proof or a combination method, including a combination of circumstantial and direct proofs.

Abodeely, 801 F.2d at 1023. *See also United States v. Smith*, 890 F.2d 711, 713 (5th Cir.1989) (net worth and specific items methods of proof combined in a section 7201 prosecution).

31.04 **PROOF OF NET WORTH -- GENERALLY**

In using the net worth method, the government must:

1. Establish an opening net worth with reasonable certainty, *i.e.*, the defendant's net worth at the beginning of the prosecution year.

2. Establish the defendant's net worth at the end of the prosecution year, with any excess over opening net worth representing the net worth increase.

3. Establish a likely source of taxable income from which the jury could find the net worth increase sprang; or, in the alternative, negate nontaxable sources of income.

4. Negate "reasonable explanations" by the taxpayer inconsistent with guilt.

Holland v. United States, 348 U.S. 121 (1954). *See also United States v. Massei*, 355 U.S. 595 (1958); *United States v. Notch*, 939 F.2d 895, 898 (10th Cir. 1991); *United States v. Blandina*, 895 F.2d 293, 301 (7th Cir. 1989); *United States v. Koskerides*, 877 F.2d 1129, 1137 (2d Cir. 1989); *United States v. Scrima*, 819 F.2d 996, 999 (11th Cir. 1987); *United States v. Tracey*, 675 F.2d 433, 435 (1st Cir. 1982); *United States v. Scott*, 660 F.2d 1145, 1147 (7th Cir. 1981); *United States v. Dwoskin*, 644 F.2d 418, 420, 422 (5th Cir. 1981); *United States v. Grasso*, 629 F.2d 805, 807 (2d Cir. 1980); *United States v. Hamilton*, 620 F. 2d 712, 714 (9th Cir. 1980); *United States v. Goichman*, 547 F.2d 778, 781 (3d Cir. 1976); *United States v. Bethea*, 537 F.2d 1187, 1188-89 (4th Cir. 1976).

31.05 **OPENING NET WORTH**

31.05[1] **Proof -- "Reasonable Certainty"**

Net worth increases are determined by establishing a taxpayer's net worth (assets minus liabilities) at the beginning of a given year and then comparing this beginning net worth with the taxpayer's net worth at the end of the year. December 31 of the year preceding the first prosecution year (the opening net worth) is the point from which net worth increases are measured. For example, if the first prosecution year, or the year to be measured, is 1993, then the defendant's net worth as of December 31, 1992, would be the opening net worth from which to determine whether the defendant's net worth increased or decreased in 1993. The defendant's 1993 ending net worth would in turn become the opening net worth for 1994, and so on.

Establishing an opening net worth can be equated to the process followed when a person goes on a diet. One of the first things that a doctor does is weigh the patient to have a starting point from which to determine whether the patient has gained or lost weight. The patient is thereafter weighed at intervals, and comparisons are made with the weight at the previous weighing to determine whether or not the diet is working. The same process basically is followed in a net worth computation, except that the "weighing" is of the defendant's net worth or wealth on an annual basis.

The Supreme Court described the need to establish an opening net worth, and the standard of proof required to do so:

> Establishing a Definite Opening Net Worth. We agree with petitioners that an essential condition in cases of this type is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion in this sum of all assets on hand at the outset.

Holland v. United States, 348 U.S. 121, 132 (1954).

While every effort should be made to obtain all of the assets and liabilities of the defendant at the starting point, the government does not have to establish the starting point, or opening net worth, "to a mathematical certainty and each case presents its own peculiar difficulties." *Smith v. United States*, 236 F.2d 260, 266-67 (8th Cir. 1956); *United States v. Gardner*, 611 F.2d 770, 775 (9th Cir. 1980). It is sufficient if the government establishes the defendant's opening net worth with reasonable certainty -- more than this is not required. *Holland*, 348 U.S. at 132; *United States v. Terrell*, 754 F.2d 1139, 1145 (5th Cir. 1985); *United States v.*

Sorrentino, 726 F.2d 876, 879 (1st Cir. 1984); *United States v. Greene*, 698 F.2d 1364, 1372 (9th Cir. 1983); *United States v. Goldstein*, 685 F.2d 179, 181 (7th Cir. 1982); *United States v. Breger*, 616 F.2d 634, 635 (2d Cir. 1980); *United States v. Carriger*, 592 F.2d 312, 313 (6th Cir. 1979); *United States v. Honea*, 556 F.2d 906, 908 (8th Cir. 1977); *United States v. Goichman*, 547 F.2d 778, 781 (3d Cir. 1976);.

Once the government has established the defendant's opening net worth with reasonable certainty, the defendant remains silent "at his peril." *United States v. Stone*, 531 F.2d 939, 942 (8th Cir.1976); *see also Holland*, 348 U.S. at 138-39. For more information concerning the defendant's burden to come forward with reasonable leads, *see* Section 31.13, *infra*, regarding the "reasonable leads doctrine."

Finally, the government is not required to prove every item in a net worth statement submitted in a bill of particulars. Items included in the starting point prior to trial may vary somewhat from the evidence admitted at trial. The Seventh Circuit stated that:

> This net worth statement, which was introduced into evidence as Government's Exhibit 8, was, in essence, a bill of particulars. There is no merit in defendant's assertion that these items must be included in the starting point. There were several items contained in this statement, some of which favored defendant and some Government, which were not substantiated during the trial by admissible evidence. Government's starting point must be based upon items which are supported by evidence introduced during trial. It is certainly not unusual in cases of this type for the starting point as proved during the trial to vary from the bill of particulars or indictment which are prepared prior to trial.

United States v. Mackey, 345 F.2d 499, 505 (7th Cir. 1965).

31.05[2] **Thorough Investigation a Necessity**

An extremely thorough investigation is crucial in proving that the government established the defendant's opening net worth with reasonable certainty. As the Ninth Circuit noted, when the government chooses to proceed against a defendant using the net worth method of proof, "the Government assumes a special responsibility of thoroughness and particularity in its investigation and presentation." *United States v. Hall*, 650 F.2d 994, 999 (9th Cir. 1981). The burden on the government has been described as follows:

> The Government must affirmatively prove an initial amount available to the taxpayer, with evidence that excludes the possibility that the defendant relied on previously accumulated assets rather than unreported taxable income, *United States v. Marshall*, 557 F.2d 527, 530 (5th Cir. 1977), without refuting all possible speculation as to sources of funds, however.

McFee v. United States, 206 F.2d 872, 874 (9th Cir. 1953), *vacated and remanded*, 348 U.S. 905 (1955), *aff'd*, 221 F.2d 807 (9th Cir.1955).

In *United States v. Smith*, 890 F.2d 711, 713 (5th Cir. 1989), the Fifth Circuit stated that "[w]e join the Seventh Circuit in observing that sloppy or mediocre financial and accounting evaluation upon which a conviction is obtained can be the genesis for reversal." *See also United States v. Terrell*, 754 F.2d 1139, 1145 (5th Cir. 1985) (the government must conduct a meticulous investigation, and the investigation techniques and figures are subject to close scrutiny); *United States v. Breger*, 616 F.2d 634, 635-36 (2d Cir.1980).

A good example of a thorough and detailed investigation is found in

United States v. Terrell, 754 F.2d 1139 (5th Cir.1985), in which the defendant was convicted of evasion for the years 1976 through 1979, and the government began its investigation of Terrell's funds with the year 1967. Noting that "we can only be surprised by appellant's attack on the thoroughness of the Government's investigation", the court described the investigation as follows:

> The investigation consumed three and one-half years. Approximately 20 agents canvassed public records to determine the extent of appellant's holdings. Thirty banks were contacted, and 20 banks produced documents or witnesses. Nearly 300 potential witnesses were interviewed, many of them several times. IRS agents identified in excess of 70 assets purchased and sold by Terrell, and questioned third parties involved in these transactions. Additionally, every expenditure made by Terrell was traced including all cashier's checks traced back to their sources to determine how they were purchased.

Terrell, 754 F.2d at 1147-48. For another example of the detailed steps required to conduct a net worth investigation, *see United States v. Sorrentino*, 726 F.2d 876, 880 (1st Cir. 1984).

When using the net worth method, the scope of the investigation and the evidence developed must be carefully examined with the goal of ascertaining whether the evidence establishes to a reasonable certainty all of the defendant's assets and liabilities. If the investigation failed to establish an opening net worth with reasonable certainty, the investigation must be continued until sufficient additional evidence has been developed.

31.05[3] **Evidence Establishing Opening Net Worth**

A legally sufficient opening net worth computation requires an extensive and thorough investigation by the Internal Revenue Service agent. The opening net worth must include all of the defendant's assets that are reasonably discoverable, including assets derived from nontaxable sources of income, such as gifts, loans, and inheritances, as well as assets derived from taxable income. It would distort taxable income for the year in which taxable income is being computed if assets derived from nontaxable sources were omitted from the starting point.

For example, assume that the prosecution year is 1995 and in 1994 the taxpayer inherited or borrowed $100,000, which is not accounted for in the opening net worth. If the defendant purchases a house with the $100,000 in 1995, which is reflected on the defendant's 1995 net worth as an asset, the net worth computation would incorrectly attribute a net worth increase of $100,000 to the defendant in 1995. The effect of this error would be to overstate the defendant's income for 1995 because he had the $100,000 at the beginning of the year. It is important that gifts, inheritances, and other nontaxable sources of income acquired during the year for which taxable income is being computed are subtracted from the calculated net worth increase in order to correctly compute the taxable income under the net worth method.

In *United States v. Breger*, 616 F.2d 634 (2d Cir.1980), the defendant was convicted of evasion and filing false income tax returns for the years 1972 through 1974. In upholding the starting point established by the government at trial, the court commented:

> We think the Government met its burden here. It used information gleaned from a 1969 mortgage application, traced a real estate and cash inheritance from appellant's mother in 1968, and investigated bond statements and checking accounts in order to ascertain appellant's access to funds as of January 1, 1972. We note that appellant adduced no specific evidence, such as a cash hoard, to suggest that the starting point was inaccurate or misleading.

Breger, 616 F.2d at 634.

Prior income tax returns of a defendant are relevant and can play a significant role in developing a defendant's opening net worth. Thus, in *United States v. Mackey*, 345 F.2d 499, 504 (7th Cir. 1965), the starting point of the net worth computation was December 31, 1955, and the court upheld the use by the government of "the income tax returns of defendant and his wife from 1929 through December 31, 1955, as a guide in determining defendant's net worth at the starting point." Additionally, net worth statements submitted by the defendant either to the government or to financial institutions can be particularly helpful in establishing an opening net worth. *See*, *e.g.*, *Smith v. United States*, 348 U.S. 147, 149 (1954); *United States v. Honea*, 556 F.2d 906, 908 (8th Cir. 1977); *United States v. Balistrieri*, 403 F.2d 472, 479 (7th Cir. 1968), *vacated on other grounds*, 395 U.S. 710 (1969).

In *United States v. Mastropieri*, 685 F.2d 776, 785 (2d Cir.1982), the court noted that less stringent standards with respect both to establishing opening net worth and to negating non-taxable income sources are justified in a case where the defendants were shown to have gone to great lengths to conceal their unreported increases in wealth. While the court observed that the investigation in that case should not be regarded as a model, the case does furnish an example of a number of the steps that must be taken to establish an opening net worth. *Mastropieri*, 685 F.2d at 779, 783. [FN2]

For additional cases holding that the government's evidence was sufficient to establish the defendant's opening net worth with reasonable certainty, *see United States v. Greene*, 698 F.2d 1364, 1372 (9th Cir. 1983) (jury could draw adverse inferences from the late stage at which defense evidence was disclosed in spite of a motion for reciprocal discovery); *United States v. Goldstein*, 685 F.2d 179, 181 (7th Cir. 1982) (evasion charged for three years, conviction on only one year, sufficient if opening net worth established for year of conviction); *United States v. Dwoskin*, 644 F.2d 418, 420 (5th Cir. 1981) (opening net worth based on a financial statement signed by the defendant and submitted to a bank); *United States v. Schafer*, 580 F.2d 774, 778 (5th Cir.1978); *United States v. Giacalone*, 574 F.2d 328, 331 (6th Cir. 1978); *United States v. Honea*, 556 F.2d 906, 908 (8th Cir. 1977); *United States v. Mancuso*, 378 F.2d 612 (4th Cir. 1967), *amended*, 387 F.2d 376 (4th Cir. 1967); *United States v. Goichman*, 407 F.Supp. 980, 986 (E.D. Pa. 1976), *aff'd*, 547 F.2d 778 (3d Cir. 1976).

31.05[4] **Opening Net Worth Not Established**

In a relatively small number of cases, the courts have found the government's proof of the defendant's opening net worth insufficient to support a conviction. For the most part, these are earlier cases, but they furnish examples of pitfalls that must be avoided if the opening net worth is to be established with reasonable certainty.

For an example of an erroneous opening net worth computation, *see United States v. Achilli*, 234 F.2d 797, 804 (7th Cir. 1956), *aff'd on other grounds*, 353 U.S. 373 (1957). In *Achilli*, one count of a three-count conviction was reversed because the value of a residence sold by the defendant in the first prosecution year (1946) was erroneously omitted from the opening net worth computation and the error accounted for almost 80 percent of the deficit shown by the government's computation. The error seems to have resulted from an oversight by the government, because the sale of the residence omitted from the defendant's opening net worth was reported in the capital gains schedule of the defendant's 1946 return. Since the tax return was the only evidence with respect to the time when the defendant acquired the property, the government conceded that the property should have been included as an asset in the computation of the defendant's net worth as of December 31, 1945. *Achilli*, 234 F. 2d at 804. *See also United States v. Keller*, 523 F.2d 1009, 1011 (9th Cir. 1975) (because the government failed to pursue leads (regarding home improvements and furnishings) which

were reasonably susceptible of being checked, the opening net worth for 1967 was not reasonably certain and the evidence as to the 1967 count was insufficient to go to the jury).

The importance of the testimony given by the agent who presents the government net worth computation and the necessity for testifying fully is illustrated in *Merritt v. United States*, 327 F.2d 820, 821 (5th Cir. 1964). The *Merritt* court reversed a tax evasion conviction because the government failed in its burden of identifying which of the defendant's assets had not been included in the opening net worth statement. The court based its decision on the following testimony of the special agent who drew up the net worth schedule:

> Q. As a matter of fact don't you know that . . . this taxpayer owned assets and had assets that you didn't even take into account in this case? Don't you know that of your own personal investigation?
>
> A. He has some other assets, yes, sir.
>
> Q. And this doesn't include all those assets does it?
>
> A. No, sir.
>
> . . . .
>
> Q. Are you willing to swear under oath that these assets represented in your net worth schedule are all and complete the assets of this taxpayer and all and complete the liabilities of this taxpayer?
>
> A. I know there are other assets of the taxpayer.
>
> . . . .
>
> A. My investigation disclosed that the taxpayer would have other assets. I know of no other liabilities.

Merritt, 327 F.2d at 821. The appellate court observed that "[n]either counsel asked the Special Agent what these other assets were, and his testimony does not reveal what he had in mind." *Merritt*, 327 F.2d at 821. Thus, the appellate court was unable to "determine whether these assets were realty or personalty, or whether they were disposed of during the years in question." *Merritt*, 327 F.2d at 822.

The *Merritt* case clearly demonstrates the requirement to review the net worth computation in depth with the special agent and to establish through testimony that the starting point includes, to a reasonable certainty, all of the defendant's assets and liabilities. On occasion, the agent will omit items from the net worth schedules for good reason. In that event, the agent should questioned on direct examination regarding what these items were and why he made the determination to omit those particular items.

31.06 **CASH ON HAND**

31.06[1] **Definition -- Need to Establish**

As one court observed, "the most frequent challenge to the government's computations in a net worth case is the opening cash balance." *United States v. Schafer*, 580 F.2d 774, 779 (5th Cir. 1978). A defendant's claim of cash on hand is commonly referred to as a cash hoard defense. A typical cash hoard defense asserts that the defendant in earlier years received money from such sources as gifts from family members or friends, or an inheritance, which he then spent during the prosecution period. The Supreme Court described the cash hoard defense as follows:

> Among the defenses often asserted is the taxpayer's claim that the net worth increase shown by the Government's statement is in reality not an increase at all because of the existence of substantial cash on hand at the starting point. This favorite defense asserts that the cache is made up of many years' savings which for various reasons were hidden and not expended until the prosecution period. Obviously, the Government has great difficulty in refuting such a contention.

Holland v. United States, 348 U.S. 121, 127 (1954).

While it is often difficult to disprove the existence of a cash hoard, the government must establish with reasonable certainty the amount of cash that the defendant had in his possession at the beginning of the tax period. *United States v. Wilson*, 647 F.2d 534, 536 n.1 (5th Cir. 1981). The necessity for establishing cash on hand "with reasonable certainty" is well summarized in *United States v. Terrell*, 754 F.2d 1139, 1146-47 (5th Cir.1985):

> The question of whether a defendant has a substantial amount of cash-on-hand at the beginning of the indictment period must be carefully investigated because the existence of a cash hoard could greatly distort the net worth evaluation. Unaccounted for funds that surface during the course of the net worth evaluation might be explained by the fact that a defendant accumulated large sums of cash which he kept on hand and began to spend during the indictment period.

See also United States v. Pinto, 838 F.2d 426, 431 (10th Cir. 1988).

A cash hoard defense often can be refuted by circumstantial evidence establishing that the defendant either had no cash hoard or spent it before the prosecution period. *United States v. Ford*, 237 F.2d 57 (2d Cir. 1956), *vacated as moot*, 355 U.S. 38 (1957). One way to defeat such a claim is to show that the family member or friend alleged to be the source of the cash did not have sufficient resources to give the defendant the amount claimed. *See United States v. Breger*, 616 F.2d 634, 636 (2d Cir.1980); *McGarry v. United States*, 388 F.2d 862, 865 (1st Cir. 1967); *United States v. Holovachka*, 314 F.2d 345, 354-55 (7th Cir.1963) (gifts and loan defense). *See also United States v. Calderon*, 348 U.S. 160, 165 (1954); *Friedberg v. United States*, 348 U.S. 142, 143 (1954).

While cash on hand does include the money that a defendant habitually carries in his pocket, *Calderon*, 348 U.S. at 162, the concept of cash on hand is more expansive. It includes all monies or cash readily available to the defendant which are not deposited in a bank or other institution. Thus, cash on hand can include: monies that the defendant had in his safe or his business, *Calderon*, 348 U.S. at 162, and cash kept in a safe deposit box and money buried in the defendant's backyard. *United States v. Bethea*, 537 F.2d 1187, 1190 (4th Cir. 1976); *United States v. Carter*, 462 F.2d 1252, 1255-56 (6th Cir.1972).

Whenever the defendant claims a cash hoard prior to indictment, the prosecutor should attempt to learn the amount of this cash hoard, its source, when it was received, where it was kept, and when and for what purpose it was used. Sometimes, the transactions giving rise to the cash hoard occurred long before the prosecution period. *Holland*, 348 U.S. at 127. Although the government must eliminate the possibility of a cash hoard when determining the defendant's cash on hand, not every far fetched explanation offered by a defendant must be accepted at face value. *See United States v. Smith*, 890 F.2d 711 (5th Cir. 1989) (defendant never disclosed the existence and source of cash transactions to the Special Agent during the investigation but at trial the defendant's spouse claimed to have $23,000 in cash in a flower vase and to have saved large cash gifts from her parents). For a cash hoard to have any bearing on a net worth computation, the defendant must have spent all or part of it during the prosecution years on assets or expenditures that appear in the

government's net worth statement. If the cash hoard remains the same throughout the prosecution period, this money has no effect on the defendant's net worth. *United States v. Giacalone*, 574 F.2d 328, 331-33 (6th Cir. 1978). The failure to use the cash hoard during the prosecution years means that any assets acquired during those years were acquired with other funds. *See* Section 31.08[2], *infra*.

As a practical matter, once the evidence establishes that the defendant had cash available at the beginning of the prosecution period, the government must produce evidence from which an inference can be drawn that the cash was not utilized during the indictment period. Otherwise, any available cash on hand must be subtracted from the computation reflecting the net worth increase and nondeductible expenditures. If it cannot be established that the cash hoard remained constant throughout the prosecution period, then it must be assumed that any computed net worth increase and nondeductible expenditures may be the result of the spending of the pre-existing cash. *See McGarry*, 388 F.2d at 866.

31.06[2] **Jury Question -- Burden of Proof**

The existence of cash on hand at the beginning of the prosecution period presents a factual issue for determination by the jury. *Holland v. United States*, 348 U.S. 121, 134 (1954); *United States v. Calderon*, 348 U.S. 160, 162-63 (1954); *United States v. Breger*, 616 F.2d 634, 635 (2d Cir. 1980); *United States v. Carter*, 462 F.2d 1252, 1256 (6th Cir. 1972); *Hayes v. United States*, 407 F.2d 189, 193 (5th Cir.1969); *McGarry v. United States*, 388 F.2d 862, 868 (1st Cir. 1967); *United States v. Vardine*, 305 F. 2d 60, 64-65 (2d Cir. 1962) (conflicting testimony left to the jury and government properly based its net worth summary on its version of the facts); *Fowler v. United States*, 352 F.2d 100, 107 (8th Cir. 1965).

The foregoing cases demonstrate that as long as there is evidence from which a jury can conclude that the government has established the amount of cash on hand with reasonable certainty, the defendant is not entitled to a judgment of acquittal on this issue. *See*, *e.g.*, *United States v. Blandina*, 895 F.2d 293, 302 (7th Cir. 1989); *United States v. Wilson*, 647 F.2d 534, 536 n.1 (5th Cir. 1981); *Breger*, 616 F.2d at 635.

Once the government has established that a thorough investigation failed to uncover evidence of cash on hand, the burden shifts to the defendant to come forward with evidence of cash and he remains silent at his peril. *United States v. Mackey*, 345 F.2d 499, 506 (7th Cir. 1965). This burden arises because "[w]hether defendant had substantial sums of cash at the starting point is a matter within defendant's knowledge." *Mackey*, 345 F.2d at 506. *See also Holland*, 348 U.S. at 138-39; *United States v. Mastropieri*, 685 F.2d 776, 785 (2d Cir. 1982); *Fowler*, 352 F.2d at 107; *United States v. Holovachka*, 314 F.2d 345, 354 (7th Cir. 1963).

31.06[3] **Amount of Cash on Hand**

The net worth computation must reflect the amount of the defendant's cash on hand for each year. However, once the government has established the initial cash on hand, it becomes a matter of showing for a subsequent year the amount of any prior cash that the defendant still had on hand plus any cash on hand acquired during the year under consideration. Any cash on hand acquired during a prosecution year, which is still on hand at the end of the year, will increase the defendant's net worth unless the cash on hand was derived from a nontaxable source, such as a gift or inheritance.

The amount of cash on hand reflected in the defendant's opening net worth will depend on the evidence established by the investigation. In *United States v. Goldstein*, 685 F.2d 179 (7th Cir. 1982), the defendant was charged with evasion and was acquitted for the tax years 1974

and 1975, but convicted for the tax year 1976. The government established the defendant's opening net worth as of 1973 and thereafter introduced evidence of the defendant's net worth for each of the years 1974, 1975, and 1976. With regard to the defendant's argument that cash on hand was underestimated by the government, the court pointed out that the government could establish a 1976 opening net worth by establishing a net worth in an earlier year and then calculating the effect of income and disbursements. The court concluded that the government need not prove the cash on hand at the beginning of each year with evidence independent of the other years. *Goldstein*, 685 F.2d at 181. *Accord United States v. Pinto*, 838 F.2d 426, 431-32 (10th Cir. 1988). Thus, the government's calculations of income and disbursements based on a starting point were adequate to prove the opening net worth for 1976.

In some instances, cash on hand may be appropriately reflected as zero. *See*, *e.g.*, *United States v. Mastropieri*, 685 F.2d 776, 779 (2d Cir.1982); *United States v. Goichman*, 407 F. Supp. 980, 986 (E.D. Pa.), *aff'd*, 547 F.2d 778 (3d Cir. 1976). In other instances, the evidence may be such that cash on hand can be reflected as a nominal amount. *See*, *e.g.*, *United States v. Carriger*, 592 F.2d 312, 314 (6th Cir. 1979) ($500); *Goldstein*, 685 F.2d at 181 ($100). In *Carriger*, cash on hand had no effect on the defendant's net worth because the evidence established that the defendant had $500 in cash on hand at the beginning of the prosecution period and $500 on hand at the end of the prosecution period. Thus, there was no increase or decrease in the defendant's net worth arising from cash on hand.

There are also instances where the government investigation indicates a negative cash position, *i.e.*, that an analysis of the defendant's financial transactions in years prior to the prosecution period indicates that the defendant spent more than was available on the basis of his prior returns.

The facts of a case may be such that the evidence justifies an assumption that any cash on hand that did exist remained constant, though unknown, throughout the period covered. This situation arose in *United States v. Giacalone*, 574 F.2d 328 (6th Cir. 1978). In *Giacalone*, the defendant was a professional gambler, and the net worth statement assumed the existence of a bank roll of cash which remained approximately the same throughout the period covered. The government in its computation used a dash rather than a dollar amount to represent the cash on hand. The dashes symbolized an unknown, presumably constant, amount. The court concluded that the use of dashes did not invalidate the net worth statement and that "[t]he effect of using the dashes is no different from the use of zeroes approved in *United States v. Goichman*, [407 F. Supp. 980 (E.D. Pa. 1976), *aff'd*, 547 F.2d 778 (3d Cir. 1976)]." *Giacalone*, 574 F.2d at 331-33. Reflecting cash on hand with dashes was a practical solution because it avoided "the untenable assumption that a professional gambler could operate without any cash." *Giacalone*, 574 F.2d at 333. *Accord*, *United States v. Scrima*, 819 F.2d 996 (11th Cir. 1987) (floating cash or "dash" method approved in prosecution of a marijuana smuggler).

31.07 **EVIDENCE OF CASH ON HAND**

31.07[1] **Evidence of Financial Deprivation**

In establishing cash on hand and disproving a claim of a cash hoard, the government may use circumstantial evidence. In *Holland v. United States*, 348 U.S. 121, 132 (1954), the defendants claimed opening cash on hand of $113,000 and the government allowed $2,153.09. The government did not introduce any direct evidence to dispute the defendant's claim. Instead, the government relied on the inference that anyone who had the cash the defendants claimed to have would not have "undergone the hardship and privation endured by the Hollands all during the late 20's and throughout

the 30's." *Holland*, 348 U.S. at 133. The case provides an excellent example of a thorough investigation, which traced the financial picture of the Hollands as far back as 1913 (the first prosecution year was 1948), and serves as a model for the type of circumstantial evidence that is admissible to refute a cash hoard defense. Another example of the government defeating a cash hoard defense by "painstakingly" tracing the defendant's finances over a period of years can be found in *Friedberg v. United States*, 348 U.S. 142, 143 (1954) (decided the same day *Holland*). *See also United States v. Carter*, 462 F.2d 1252 (6th Cir. 1972). *See also United States v. Ford*, 237 F.2d 57, 59, 63 (2d Cir. 1956), *vacated as moot*, 355 U.S. 38 (1957); *Gariepy v. United States*, 189 F.2d 459, 461 (6th Cir. 1951).

On the other hand, the government must introduce evidence which demonstrates more than the fact that the defendant was poor at an early point in his life. The evidence must trace the defendant's financial history up to the starting point. "Proof that the taxpayer was impoverished by the depression, that he was working for his meals at $8 a week in 1935, is too remote, absent proof of the taxpayer's financial circumstances in the intervening years." *United States v. Calderon*, 348 U.S. 160, 164 (1954) (first prosecution year was 1946).

31.07[2] **Admissions of Defendant**

In establishing an opening net worth, the government will often rely on statements made by the defendant to investigating agents, as well as to third parties. *See*, *e.g.*, *Holland v. United States*, 348 U.S. 121, 128 (1954) (statements made to agents); *United States v. Goldstein*, 685 F.2d 179, 182 (7th Cir. 1982) (admissions in the form of financial statements). Statements made by a defendant are admissible as admissions. Fed. R. Evid. Rule 802(d)(2)(A).

Admissions are a fertile source of information, useful both in establishing cash on hand and in refuting cash hoard defenses. A distinction must be made, however, between admissions made by a defendant prior to the crime (pre-offense admissions) and admissions made after the crime (post-offense admissions).

31.07[2][a] **Pre-Offense Admissions**

Admissions made by a defendant prior to the crime do not have to be corroborated. *Warszower v. United States*, 312 U.S. 342, 347 (1941); *United States v. Soulard*, 730 F.2d 1292, 1298 (9th Cir. 1984); *United States v. Hallman*, 594 F.2d 198, 200-01 (9th Cir. 1979) (corroboration not required of admission in financial statement filed by the defendant with a bank prior to the investigation conducted by the Internal Revenue Service); *Fowler v. United States*, 352 F.2d 100 (8th Cir. 1965) (loan application was filed before crimes in controversy occurred, and admissions made on application need not be corroborated).

31.07[2][b] **Post-Offense Admissions**

As a general rule, post-offense admissions must be corroborated. *United States v. Calderon*, 348 U.S. 160 (1954); *Smith v. United States*, 348 U.S. 147, 152-53 (1954). Generally speaking, in a criminal tax case, a post-offense admission would be a statement made after the filing of a false return or, if no return is filed, after the return was due.

In *Smith*, 348 U.S. 147, the defendant's opening net worth was based on a signed net worth statement given to the investigating agents by the defendant, as well as other extrajudicial admissions made by the defendant. *Smith*, 348 U.S. at 152. The Court found that the government could corroborate the defendant's statement in one of two ways: (1) either by substantiating the opening net worth directly; or (2) by

independent evidence as to the defendant's conduct during the prosecution years, "which tends to establish the crime of tax evasion without resort to the net worth computation." *Smith*, 348 U.S. at 157-58. The government successfully relied on the second method to corroborate the defendant's post-offense admissions in *Calderon*, by showing a substantial increase in the defendant's assets that were sufficiently at variance with his reported income to support an inference of tax evasion. *Calderon*, 348 U.S. at 166- 67.

Corroborative evidence of post-offense statements by a defendant regarding cash on hand is sufficient if it shows a substantial income deficiency for the overall prosecution period. It is not necessary for the corroborative evidence, as opposed to the evidence as a whole, to establish that there was a deficiency for each of the years in issue. *Calderon*, 348 U.S. at 168. *Accord United States v. Vardine*, 305 F.2d 60, 65 (2d Cir. 1962) (evidence that defendant periodically borrowed money to meet payrolls and other indebtedness, and that there were frequently judgments outstanding against him tended to corroborate figures defendant gave to agents). [FN3]

The Fifth Circuit, however, has held that it is not always necessary to corroborate post-offense admissions as to cash on hand. In *United States v. Normile*, 587 F.2d 784, 786 (5th Cir. 1979), proof of cash on hand was based on the defendant's statement to the agent that "he kept no more than $100 in cash because he did not feel safe having larger amounts around." In response to the defendant's claim that the government failed to corroborate this statement, the court stated that it "was not necessary for the government to seek to corroborate the taxpayer's statement; indeed the inherent secrecy of the cash hoard makes it impossible for any but the keeper to know even of its existence, let alone the amount." *Normile*, 587 F.2d at 786. Nevertheless, the court found that independent evidence of substantial bank accounts did "tend to corroborate" the defendant's admission, even though the government introduced no evidence to corroborate the admission directly. *Normile*, 587 F.2d at 786-87. *See United States v. Terrell*, 754 F.2d 1139, 1147 (5th Cir. 1985) (corroboration requirement does not necessarily extend to admissions relating to cash-on-hand); *United States v. Wilson*, 647 F.2d 534, 536 n.1 (5th Cir. 1981). *But see United States v. Meriwether*, 440 F.2d 753, 756-57 (5th Cir. 1971). *See also United States v. Scrima*, 819 F.2d 996 (11th Cir. 1987) in which a marijuana smuggler told agents during the investigation that he maintained only $500 in cash on hand but claimed at trial that he had an undisclosed cash hoard of $375,000 at the beginning of the indictment period. The court found that "the government is not required to corroborate the taxpayer's statement with respect to his cash on hand at the beginning of the tax period. After everything possible is done to verify the opening net worth, the issue of the amount of the defendant's cash hoard is properly submitted to the jury." *Scrima*, 819 F.2d 996 n.3

31.07[3] **Tax Returns As Admissions**

"Statements made in an income tax return constitute admissions." *United States v. Dinnell*, 428 F. Supp. 205, 208 (D. Az. 1977), *aff'd without published opinion*, 568 F.2d 779 (9th Cir. 1978). *See United States v. Hornstein*, 176 F.2d 217, 220 (7th Cir. 1949) (cost of goods sold). Items reported on returns that are the subject of the prosecution, as well as earlier filed returns, are pre-offense admissions which do not have to be corroborated. *United States v. Burkhart*, 501 F.2d 993, 995 (6th Cir. 1974) (citing cases). The government may take the taxpayer's reported income as an admitted amount earned from designated sources. As to the admissibility of a defendant's tax returns, *see also* Fed. R. Evid. Rule 801(d)(2)(A).

The defendant's income tax returns are frequently used in a net worth case as a guide in determining the defendant's net worth at the starting point. *See*, *e.g.*, *United States v. Mackey*, 345 F.2d 499, 504 (7th Cir. 1965). Admissions found in the defendant's tax returns

for earlier years can be particularly helpful in negating a cash hoard defense when the returns show that reported income in previous years was insufficient to enable the defendant to save any appreciable amount of money. *Friedberg v. United States*, 348 U.S. 142, 143-44 (1954); *Holland v. United States*, 348 U.S. 121, 134 (1954); *United States v. Terrell*, 754 F.2d 1139, 1147 (5th Cir. 1985); *United States v. Hamilton*, 620 F.2d 712, 715 (9th Cir. 1980) *United States v. Bush*, 512 F.2d 771, 772 (5th Cir. 1975) (defendant's tax return reflecting zero cash on hand supported government position); *United States v. Ross*, 511 F.2d 757, 761 (5th Cir. 1975); *United States v. Carter*, 462 F.2d 1252, 1255 (6th Cir. 1972); *United States v. Northern*, 329 F.2d 794, 795 (6th Cir. 1964) (value of machines in inventory taken from defendant's tax return); *Leeby v. United States*, 192 F.2d 331, 333 (8th Cir. 1951);.

31.07[4] **Statements Given to Financial Institutions**

Statements given to financial institutions are another fruitful source of evidence regarding a taxpayer's cash on hand, as well as other assets and liabilities. *Friedberg v. United States*, 348 U.S. 142, 144 (1954) (loan application); *United States v. Dwoskin*, 644 F.2d 418, 420 (5th Cir. 1981) (financial statement); *United States v. Hallman*, 594 F.2d 198, 200 (9th Cir. 1979) (financial statement); *Fowler v. United States*, 352 F.2d 100, 107 (8th Cir. 1965) (loan applications); *United States v. Norris*, 205 F.2d 828, 829 (2d Cir. 1953) (loan application).

In *Dwoskin*, 644 F.2d at 420, the defendant's opening net worth, including cash on hand and cash unrestricted in banks, was based on a signed financial statement the defendant had submitted to a bank. The government did not include in its cash on hand figure $11,000 in an account on which the defendant held as a trustee for his children because there was no evidence that the defendant used the funds; indeed, the account had a higher balance subsequent to the prosecution years.

Financial statements also can be used to impeach a defendant testifying at trial. Thus, in *Bateman v. United States*, 212 F.2d 61, 67 (9th Cir. 1954), the defendant testified that he had $13,000 in cash and the government introduced, "as competent impeaching evidence," a financial statement that the defendant had given a bank showing cash of only $100.

31.07[5] **Defendant's Books and Records**

The defendant's business books and records are admissible, as records of a regularly conducted business activity, Fed. R. Evid. Rule 803(6), and as admissions. *United States v. Hornstein*, 176 F.2d 217, 220 (7th Cir. 1949). *See Paschen v. United States*, 70 F.2d 491, 501 (7th Cir. 1934) (not necessary for government to prove the books and records are correct). In some instances, the defendant's books and records can establish the starting point. *See*, *e.g.*, *United States v. Chapman*, 168 F.2d 997, 1002 (7th Cir. 1948) (government entitled to expect that books furnished for examination by taxpayer would be correct, and a verification of their accuracy cannot be called an 'uncorroborated admission').

The defendant's books and records also can be used to refute an attack on the computation of cash on hand. In *United States v. Mackey*, 345 F.2d 499, 505 (7th Cir. 1965), an annual statement of the defendant's corporation revealed that the corporation had less cash than the amount claimed by the defendant.

Finally, it should be noted that entries in the books and records of the defendant are valuable in establishing the financial history of the defendant in early years, the defendant's business activities during the prosecution years, and the defendant's assets and liabilities.

31.07[6] **Statements of Accountants and Attorneys**

When the defendant directs the investigating agents to his accountant or bookkeeper for questions relating to taxes, any statements made by the accountant or bookkeeper are admissions, and agents can testify as to these statements. *United States v. Diez*, 515 F.2d 892, 896 n.4 (5th Cir. 1975); *Hayes v. United States*, 407 F.2d 189, 192 (5th Cir. 1969). Rule 801(d)(2)(D), Fed. R. Evid., provides that a statement by the defendant's agent (*e.g.*, bookkeeper) "concerning a matter within the scope of his agency or employment made during the existence of the relationship" is an admission, whether the defendant has authorized the making of the particular statement or not. *See United States v. Parks*, 489 F.2d 89, 90 (5th Cir. 1974). Statements of the defendant's bookkeeper or accountant concerning matters within the scope of their activity or employment are admissible against the defendant as admissions. Fed. R. Evid. Rule 801(d)(2)(C) or (D); *United States v. Parks*, 489 F.2d 89, 90 (5th Cir. 1974).

These cases relied upon the absence of an accountant-client privilege because the defendant, knowing that mandatory disclosure of much of the information therein is required on an income tax return, had no expectation of privacy in documents and information provided to return preparers. *Couch v. United States*, 409 U.S. 322 (1973). The Court in *Couch* also noted that no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases. *Couch*, 409 U.S. at 335 (citations omitted).

Note that the cases discussed above were decided prior to the Internal Revenue Service Restructuring and Reform Act of 1998 (the Act). Section 7525 of the Internal Revenue Code provides:

Confidentiality privileges relating to taxpayer communications

(a) Uniform application to taxpayer communication with federally authorized practitioners.

(1) General rule. With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

(2) Limitations. Paragraph (1) may only be asserted in

(A) any noncriminal tax matter before the Internal Revenue Service; and

(B) any noncriminal tax proceeding in Federal court brought by or against the United States.

(3) Definitions. For purposes of this subsection

(A) Federally authorized tax practitioner. The term "federally authorized tax practitioner" means any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code.

(B) Tax Advice. The term "tax advice" means advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice described in subparagraph (A).

Thus, by its own terms, the Act does not create an unlimited accountant- client privilege. The Act provides that the privilege may only be asserted in (A) any non-criminal tax matter before the Internal Revenue Service; and (B) any noncriminal tax proceeding in Federal court brought by or against the United States. Section 7525 (2)(A) and (B). Furthermore, it only applies to communications between a taxpayer and a federally authorized

practitioner. Thus, the privilege is not available in a criminal investigation or criminal court proceeding, but would apply in the context of a civil audit.

Additionally, the Act specifically excludes from the privilege any written communications regarding corporate tax shelters. 26 U.S.C. § 7572(b). That Section provides:

(b) Section not to apply to communications regarding corporate tax shelters. The privilege under subsection (a) shall not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii)).

Thus, written communications with a representative of a corporation in connection with efforts to persuade the corporation to participate in a tax shelter are excluded from the privilege. Note that tax shelters are defined as:

(iii) Tax shelter. For purposes of this subparagraph, the term "tax shelter" means

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

Additionally, in cases in which the accountant has been employed by the defendant's attorney to assist the attorney in communicating with the client and rendering legal advice, statements of the accountant may fall within the attorney-client privilege. *United States v. Gurtner*, 474 F.2d 297 (9th Cir. 1973); *United States v. Mierzwicki*, 500 F. Supp. 1331, 1335 (D.Md. 1980). The most familiar situation occurs when the attorney hires an accountant to assist the attorney's representation of the taxpayer. *See United States v. Kovel*, 296 F.2d 918 (2d 1961). A *Kovel* accountant is protected by an extension of the attorney-client privilege.

In the case of attorneys, statements made by a taxpayer's attorney may be admissible as admissions of a party-opponent pursuant to Fed. R. Evid. 801(d)(2) if it is shown that the statements are not barred by the attorney-client privilege. A statement by a taxpayer's attorney attorney is not privileged if it was authorized by the client and concerned the subject authorized. *United States v. Ojala*, 544 F.2d 940, 945-46 (8th Cir. 1976). The court in *Ojala* admitted into evidence the attorney's statement that the taxpayer's failure to file was not the result of his political beliefs. The court found that the "statements were made in an unequivocal manner by one who was acting as the appellant's attorney at the time, and that they referred to a matter within the scope of the attorney's authority." *Ojala*, 544 F.2d at 946. The court also noted that the taxpayer was present when the statement was made and voiced no objection. *Id.*

Another court admitted into evidence a statement by a taxpayer's attorney which contradicted the taxpayer's assertion that he had filed his tax returns. *United States v. O'Connor*, 433 F.2d 752, 755-56 (1st Cir. 1970). The *O'Connor* court observed that the attorney's statement did not exceed scope of attorney's actual authority. The court further observed that it might rule otherwise if there had been evidence that the taxpayer told his attorney not to make the statement or to "confine himself to the position adoped by the defendant." *Id.* at 756. The court

found that it was "clearly within the power and duty of the attorney to do what he could, in his own best judgment, [to aid the taxpayer]." *Id.*

Note, however, that courts have generally held that the preparation of tax returns does not constitute legal advice within the scope of the attorney-client privilege. *In Re Grand Jury Investigation (Schroeder)*, 842 F.2d 1223, 1224 (11th Cir. 1987); *United States v. Lawless*, 709 F.2d 485, 487-88 (7th Cir. 1983); *United States v. El Paso*, 682 F.2d 530, 539 (5th Cir. 1982); *United States v. Gurtner*, 474 F.2d 297, 298-99 (7th Cir. 1973). *But see Colton v. United States*, 306 F.2d 633, 637 (2d Cir. 1962) ("There can, of course be no question that the giving of tax advice and the preparation of tax returns . . . are basically matters ssufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege.").

31.07[7] **Accountant's Workpapers**

An accountant's workpapers can be useful in establishing opening net worth figures, including cash on hand, as well as in establishing assets and liabilities during the prosecution period. Prior to the Act, the workpapers could be obtained, because there was no accountant-client privilege, *Couch v. United States*, 409 U.S. 322, 335 (1973), nor a work-product privilege with respect to workpapers. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817 (1984). The Internal Revenue Service Restructuring and Reform Act of 1998, discussed above, by its plain language, applies only to communications between a taxpayer and his accountant. It does not create a work- product privilege. Presumably, both the communications and the workpapers can be acquired in criminal cases. An accountant's workpapers are records which the accountant kept in the ordinary course of business and may, with a proper foundation, be admissible as exceptions to the hearsay rule pursuant to Fed. R. Evid. Rule 803(6). Of course, it would be necessary to demonstrate that the information relied upon by the accountant was provided by the taxpayer or an individual authorized by the taxpayer to provide such information to the accountant.

31.07[8] **Source and Application of Funds Analysis**

Another method of establishing starting point cash on hand is to analyze the defendant's available finances for the years leading up to the starting point. This method is known as a source and application of funds. Using this method, the government determines the amount of money available to the defendant during the earlier years, and the amount that the defendant spent.

For example, if the evidence demonstrates that the defendant had $100,000 available from all sources, both taxable and nontaxable, and that the defendant spent $90,000, this would leave only $10,000 as cash on hand. This was the approach taken in *United States v. Terrell*, 754 F.2d 1139, 1143 (5th Cir. 1985), in which the defendant was not credited with any cash on hand on the basis of a source and application of funds analysis showing that the defendant's expenditures in prior years exceeded his reported income plus nontaxable gifts by $229,000. As in the case of establishing opening net worth, a thorough investigation is required to support a source and application of funds analysis sufficient to establish cash on hand with reasonable certainty. *Terrell*, 754 F.2d at 1146-47. *See also United States v. Goichman*, 407 F. Supp. 980, 994-95 (E.D. Pa.), *aff'd*, 547 F.2d 778 (3d Cir. 1976).

31.08 **NET WORTH ASSETS**

31.08[1] **Reflected at Cost -- Generally**

As a general rule, when establishing the net worth of a taxpayer,

assets are reflected at cost and not at fair market value. Thus, if a taxpayer buys a house for $50,000, the house is reflected as a net worth asset at $50,000, even though the house may be worth $100,000 in the year for which the taxpayer's net worth is being determined.

Assets are generally reflected in a net worth statement at cost because the net worth method is concerned not with value (which may result from appreciation rather than the receipt of taxable income) but only with actual costs and expenditures. *United States v. O'Connor*, 237 F.2d 466, 473 n.6 (2d Cir. 1956). *See United States v. Terrell*, 754 F.2d 1139, 1145 (5th Cir. 1985) (using a cost basis to determine net worth means that assets preexisting the indictment period are a source of nontaxable funds only to the extent of basis); *Hayes v. United States*, 407 F.2d 189 (5th Cir. 1969) (cost of partially constructed apartments taken from defendant's income tax return, and cost of land based on information furnished by the defendant's accountant).

As an exception to this general rule, cost is not used when the Internal Revenue Code dictates that a basis other than cost be used in determining tax consequences. For example, if services are paid for in property, then the fair market value of the property is included as compensation in gross income. Treas. Reg. § 1.61-2(d) (26 C.F.R.). In this situation, property received in exchange for services would be reflected at its fair market value in the net worth computation. For other examples of situations where an asset would be reflected at a figure other than cost, *see* 26 U.S.C. § 1014(a) (basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death); 26 U.S.C. § 1015 (basis of property acquired by gifts and transfers in trust).

31.08[2] **Across the Board Assets**

An across the board asset is an asset which the taxpayer owned in the opening year and continued to own throughout the prosecution years, with no increase or decrease in the cost of the asset. Since a net worth computation measures changes, an across the board asset does not affect a taxpayer's net worth. For example, assume that the prosecution years are 1995 through 1998, and the defendant purchased stock for $10,000.00 in 1994 and still owned the same stock at the end of 1998. There would be no change in the basis of the stock, and the effect on the defendant's net worth would be zero. Because an across the board asset does not affect the net worth computation, it has been held that it is not error to leave such an asset out of the net worth computation. *United States v. Mackey*, 345 F.2d 499, 505 (7th Cir. 1965).

It is not necessary for the government to establish the basis for every asset the taxpayer owns. *United States v. Schafer*, 580 F.2d 774, 778 (5th Cir. 1978). It is sufficient for the government to identify with reasonable specificity the basis in every asset, including cash, in which a purchase or sales transaction occurred in the tax years in question. *Schafer*, 580 F.2d at 778. Note, however, that in *Schafer*, the court assumed that possible omitted assets were across the board assets.

In *United States v. Tolbert*, 406 F.2d 81, 84 (7th Cir. 1969), the government's net worth computation reflected the defendant's accounts receivable as an across the board asset for all of the years in question. The government figure was based on a statement the defendant had given the agents. There was testimony at the trial that the accounts receivable had increased during the prosecution years. The court rejected the defendant's argument that it was reversible error not to reflect the alleged increase, observing that if the accounts receivable did increase during the prosecution years, the error in failing to reflect the increase was in the defendant's favor and did not prejudice him. The court found that there would be prejudice only if the evidence showed that the accounts receivable had decreased during the prosecution years. *Tolbert*, 406 F.2d at 84. *See also United States v. Scrima*, 819 F.2d 996, 999 (11th Cir. 1987) ("government employed the floating cash or dash formula

where cash is an unknown but constant factor throughout the net worth period"); *United States v. Terrell*, 754 F.2d 1139, 1145 (5th Cir. 1985); *United States v. Dwoskin*, 644 F.2d 418, 421 (5th Cir. 1981).

31.08[3] **Bank Accounts and Nominee Accounts**

Money in the bank represents an asset in a net worth computation. In the usual situation, it is a relatively simple matter to determine how much money the defendant had in the bank at the end of each year, with the balance being reflected in the net worth statement. However, all outstanding checks should be subtracted from the end of the year bank statement balance otherwise the balance would be inflated. *United States v. Vardine*, 305 F.2d 60, 65 (2d Cir. 1962). Similarly, deposits in transit are added to the end of the year statement balance.

In a number of instances, the taxpayer will have maintained bank accounts in the names of family members or in the names of third-party nominees. It must then be determined whether the money in the account was supplied by the defendant. If so, the bank balances are included in the defendant's net worth. This was the case in *United States v. Balistrieri*, 403 F.2d 472, 479 (7th Cir. 1968), *vacated and remanded on other grounds*, 395 U.S. 710 (1969), *aff'd after remand*, 436 F.2d 1212 (7th Cir. 1971). There, the defendant attacked the propriety of including cash that had been deposited in the bank in his name and the name of his nineteen-year old son in the defendant's net worth computation. Rejecting the defendant's argument, the court found that the jury had ample grounds to believe that the money was in fact the defendant's, since the government proved that the defendant controlled the account and withdrew a substantial amount from it. *Balistrieri*, 403 F.2d at 479. *See also Talik v. United States*, 340 F.2d 138, 141 (9th Cir. 1965) (attributing entire balance in account to defendant was justified because either the account belonged to defendant or any money belonging to the daughter was a gift from her parents).

31.08[4] **Assets and Liabilities of Husband and Wife or Children**

In determining a defendant's opening net worth, consideration must be given to assets and liabilities of a non-defendant spouse and children. Such assets and liabilities need not be included in the government's computation where the net effect of inclusion would be de minimis. The government, however, must have investigated a spouse's and/or child's assets and liabilities before deciding not to include them in the computation. *United States v. Goichman*, 407 F. Supp. 980, 995-96 (E.D. Pa.), *aff'd*, 547 F.2d 778 (3d Cir. 1976).

A failure to conduct such an investigation of the defendant's spouse resulted in a reversal in *United States v. Meriwether*, 440 F.2d 753 (5th Cir. 1971). The court held that the government failed to establish with reasonable certainty a definite opening net worth of the joint income of Meriwether and his wife, saying that the government "came near ignoring Mrs. Meriwether." *Meriwether*, 440 F.2d at 755.

The Ninth Circuit appears to disagree with the Fifth Circuit, however, holding that the government is not required to establish the net worth of the defendant's spouse as part of its prima facie case. *United States v. Hallman*, 594 F.2d 198, 200 (9th Cir. 1979). Instead, the government's duty to investigate spousal assets only arises under its obligation to negate reasonable explanations or leads furnished by the defendant. *Hallman*, 594 F.2d at 200. However, unless merited by the particular circumstances of a given case, consideration always should be given to the assets and liabilities of a spouse.

A somewhat different issue is whether the government can use a joint net worth statement for both husband and wife. The Fifth and Sixth Circuits have answered in the affirmative. In *United States v. Brown*, 667 F.2d 566 (6th Cir. 1982), both husband and wife were tried and convicted of

income tax evasion. The court concluded that the government's use of a joint net worth statement was "justified," even though the wife was the nominal owner of the business that was the source of the unreported income, because "the financial affairs of the two defendants were so intertwined as to justify a joint reconstruction of their income." *Brown*, 667 F.2d at 568.

In a non-defendant spouse case, *United States v. Giacalone*, 574 F.2d 328 (6th Cir.1978), the government's evidence showed that the defendant's wife earned no income prior to and during the prosecution years, that she made some nondeductible expenditures with funds furnished by her husband, and that she and her husband filed joint returns. Because the defendant was charged with attempting to evade taxes owed by both him and his wife, and "her financial transactions were intertwined with those of her husband," the court approved the government's use of a joint net worth statement. *Giacalone*, 574 F.2d at 333.

In *United States v. Smith*, 890 F.2d 711, 714 (5th Cir. 1989), the Fifth Circuit relied on *Brown* and *Giacalone* in rejecting a defendant's claim that the government was required to exclude assets of the defendant's spouse and child to ensure the accuracy of the net worth analysis. In *Smith*, the government excluded both the income of the defendant's daughter and gifts to the defendant's wife and daughter before arriving at a final net worth determination of the defendant and his spouse. The court stated that the "fabric of the financial blanket is so closely woven that a computation of net worth on the joint income of the spouses is clearly permissible." *Smith*, 890 F.2d at 714.

31.08[5] **Real Property**

Real property is reflected in the net worth computation at cost, unless the realty falls within one of the exceptions, such as realty received as an inheritance. Where cost cannot be established by direct evidence, a determination should be made whether the realty was purchased or sold at a time when revenue stamps were affixed to deeds pursuant to a federal statute which imposed a tax on deeds. 26 U.S.C. § 4361, repealed. If the realty was purchased or sold at a time when the tax on deeds was in effect, the revenue stamps can be used to compute the sales price of the realty. *United States v. 18.46 Acres Of Land, Etc.*, 312 F.2d 287, 289 (2d Cir. 1963); *Dickinson v. United States*, 154 F.2d 642, 643 (4th Cir. 1946); *Ramming Real Estate Co. v. United States*, 122 F.2d 892, 895 (8th Cir. 1941). On occasion, state stamps can also be used to compute the sales price.

Jointly owned property is especially common in the case of a husband and wife. For an example of a jointly owned asset properly included in full in the defendant's net worth, *see O'Connor v. United States*, 203 F.2d 301, 303 (4th Cir. 1953). *See also United States v. Costello*, 221 F.2d 668, 672 (2d Cir. 1955), *aff'd*, 350 U.S. 359 (1956); *United States v. Johnson*, 319 U.S. 503, 516 (1943) (jury could find that a string of gambling houses ostensibly conducted as separate enterprises by co-defendants was in fact a single, unified gambling enterprise owned by one defendant).

Finally, note that records of documents affecting an interest in property and statements in documents affecting an interest in property may be admissible as exceptions to the hearsay rule. Fed. R. Evid. Rules 803(14) and (15).

31.08[6] **Partnership Interest**

When the taxpayer has invested money in a partnership, the taxpayer's share of the partnership capital is reflected as an asset. *United States v. Mancuso*, 378 F.2d 612, 614-15 (4th Cir.), *amended*, 387 F.2d 376 (4th Cir. 1967). In *Mancuso*, the government had little direct evidence to establish the percentage interest the defendant had in the

partnership. Therefore, the government allocated an equal share of the partnership capital to all the partners, including the defendant, which corresponded to the distribution of profits as reported on the partnership tax returns. The government agent testified that this "conformed to the ordinary legal presumption that in absence of evidence of an agreement to the contrary the partners' interests are equal." *Mancuso*, 378 F.2d at 616.

31.08[7] **Errors in Net Worth Computation**

If there is an error in the net worth computation for one of the prosecution years, the error will not necessarily affect other prosecution years. *United States v. Keller*, 523 F.2d 1009, 1012 (9th Cir. 1975) (error did not carry over to a subsequent year since the asset was disposed of in the prior prosecution year). Moreover, even if an error does affect all of the prosecution years, the government is not required to prove its case to a mathematical certainty. If a substantial understatement remains after accounting for the error, then a guilty verdict will be upheld. *Keller*, 523 F.2d at 1012.

31.09 **LIABILITIES**

The government must present evidence of a defendant's liabilities. These liabilities are subtracted from assets in arriving at a taxpayer's net worth. As with assets, the defendant's liabilities must be established with reasonable certainty.

For examples of evidence establishing liabilities, *see United States v. Schafer*, 580 F.2d 774, 780 (5th Cir. 1978); *Beard v. United States*, 222 F.2d 84, 89 (4th Cir. 1955).. Testimony by the investigating agent as to the amount of a liability, without independent documentation or third-party testimony, is inadmissible hearsay. *See United States v. Morse*, 491 F.2d 149, 153-55 (1st Cir. 1974) (a bank deposits case, but the principle is applicable to a net worth case).

On the other hand, when the agent's investigation reveals that there were no liabilities, the agent can testify to the negative finding. It is not hearsay. *United States v. Dwoskin*, 644 F.2d 418, 423 (5th Cir. 1981); *Morse*, 491 F.2d at 154 n.8;. Otherwise stated, a witness may testify as to his or her failure to find records after a search. *United States v. Lanier*, 578 F.2d 1246, 1255 (8th Cir. 1978); *United States v. Robinson*, 544 F.2d 110, 114-15 (2d Cir. 1976); *United States v. Jewett*, 438 F.2d 495, 497-98 (8th Cir. 1971); *United States v. DeGeorgia*, 420 F.2d 889, 891-92 (9th Cir. 1969); *Charron v. United States*, 412 F.2d 657, 660 (9th Cir. 1969); *McClanahan v. United States*, 292 F.2d 630, 637 (5th Cir. 1961) ("[t]his, in fact, is frequently the only way in which a negative fact can be proved").*See also* Fed. R. Evid. Rules 803(7) and 803 (10).

As a general rule, when the defendant is a cash basis taxpayer, the net worth computation does not include accrued liabilities. *United States v. Balistrieri*, 403 F.2d 472, 479 (7th Cir. 1968), *vacated and remanded*, 395 U.S. 710 (1969), *aff'd after remand*, 436 F.2d 1212 (7th Cir. 1971). On the other hand, if the defendant has received cash or property in exchange for a liability, then the asset and liability are both included in the net worth computation whether the defendant is on a cash or accrual basis. For example, if the defendant buys a house in exchange for a mortgage, the house would be shown as an asset and the mortgage as a liability.

31.10 **NONDEDUCTIBLE EXPENDITURES**

31.10[1] **Added to Net Worth Increase**

After subtracting the ending net worth from the starting point, the resulting net worth increase is further adjusted by adding to the increase the taxpayer's nondeductible expenditures during the year, including living expenses, for items which are not reflected as assets on the net worth statement. *Holland v. United States*, 348 U.S. 121, 125 (1954); *United States v. Terrell*, 754 F.2d 1139, 1144 (5th Cir.1985); *United States v. Hamilton*, 620 F.2d 712, 714 n.1 (9th Cir. 1980);*United States v. Skalicky*, 615 F.2d 1117, 1119 (5th Cir. 1980); *United States v. Hiett*, 581 F.2d 1199, 1200 n.1 (5th Cir. 1978); *United States v. O'Connor*, 237 F.2d 466, 473 n.7 (2d Cir. 1956). "The taxpayer's nondeductible expenditures are added to the adjusted net values of the defendant's assets at the end of the subject year and, consequently, increase the figure to be compared with the opening net worth." *Hamilton*, 620 F.2d at 716. *See also*, *United States v. Scrima*, 819 F.2d 996, 999 (11th Cir. 1987).

31.10[2] **Burden on Government**

The government has the burden of establishing that the expenditures added to the net worth increase are nondeductible expenditures, as opposed to deductible expenses such as business expenses. Any addition to the net worth increase must be limited to nondeductible expenditures. *Fowler v. United States*, 352 F.2d 100, 103 (8th Cir. 1965). The government must establish the nature of an expenditure by independent documentary or testimonial evidence. *Greenberg v. United States*, 280 F.2d 472 (1st Cir. 1960) (agent's testimony regarding expenses insufficient to establish nature of expenditure).

It is improper to designate an expenditure as personal based solely on a review of the taxpayer's checks by the investigating agent and the agent's testimony that a check is either for a personal or business purpose. The agent's testimony is hearsay. *See Siravo v. United States*, 377 F.2d 469, 474 (1st Cir. 1967) (third parties testified and the court "was careful to exclude testimony by the special agent as to conversations with others"); *Johnson v. United States*, 325 F.2d 709, 711 (1st Cir. 1963).

Admissions by the defendant may establish whether expenditures are personal or business. Checks with a notation of "personal" written on them constitute a pre-offense admission. *Fowler*, 352 F.2d at 103. *See also United States v. Altruda*, 224 F.2d 935, 939 (2d Cir. 1955) (admitted personal living expenses were added to the net worth increases).

Finally, a nondeductible expenditure made by or on behalf of a spouse, children, or any third party can be added to the defendant's net worth increase where it can be shown that the defendant furnished the funds for the expenditure. *United States v. Giacalone*, 574 F.2d 328, 333 (6th Cir. 1978) (government proof traced a number of nondeductible expenditures by the wife to funds furnished by the defendant); *Ford v. United States*, 210 F.2d 313, 317 (5th Cir. 1954); . *Cf. United States v. Lawhon*, 499 F.2d 352, 355-56 (5th Cir. 1974) (citrus groves and certificates of deposit in the names of children); *United States v. Balistrieri*, 403 F.2d 472, 479 (7th Cir. 1968), *vacated and remanded on other grounds*, 395 U.S. 710 (1969), *aff'd after remand*, 436 F.2d 1212 (7th Cir. 1971) (bank account in name of defendant and his minor son).

31.10[3] **Nondeductible Expenditures -- Examples**

> Proof of non-deductible expenditures -- such as food, clothing, shelter and gifts -- is one factor in the net worth and expenditures method of proof. . . . Government tax experts routinely add living expenses to their net worth schedules.

United States v. Scott, 660 F.2d 1145, 1173 (7th Cir. 1981). *See United States v. Hamilton*, 620 F.2d 712, 716 (9th Cir. 1980).

In *Scott*, the only daily living expense the government included in its net worth calculation was food. As Attorney General of the State of Illinois, Scott traveled on state business and his travel vouchers were used as a basis for arriving at his unreimbursed food expenditures. *Scott*, 660 F.2d at 1151. In addition to food expenses, the government's net worth computation included cash travel expenses for personal trips that the government was able to document and the purchase of a stamp collection and a diamond ring. *Scott*, 660 F.2d at 1150-51.

Living expenses can be based on estimates provided by the taxpayer. In *United States v. Burdick*, 214 F.2d 768, 770 n.6 (3d Cir. 1954), *vacated*, 348 U.S. 905 (1955), *aff'd on remand*, 221 F.2d 932 (3d Cir. 1955), the government estimated the defendant's living expenses at $2,000 a year on the basis of the defendant's admission that he spent $20 to $25 a week for household expenses alone. *See also United States v. Doyle*, 234 F.2d 788, 794 (7th Cir. 1956) (expenditures for living expenses arrived at largely from defendant's own statements).

Another method of establishing living expenses is to rely on "independent estimates from the Bureau of Labor on what a person with (the taxpayer's) reported income and family and financial obligations would be expected to spend on non-deductible items." *Hamilton*, 620 F.2d at 716. Caution must be exercised, however, in using Bureau of Labor statistics estimates. The estimates are broken down into categories, such as food, clothing, household operations, alcohol, tobacco, gifts, and contributions, etc. The items selected for net worth purposes should be limited to necessities such as food, household operations, and clothing. Estimates of expenditures subject to greater variation, such as for recreation, transportation, and similar items, should not be used. Personal insurance premiums and federal income taxes paid by a taxpayer may also be added to the net worth increase. *Dawley v. United States*, 186 F.2d 978, 980 (4th Cir. 1951). In *Armstrong v. United States*, 327 F.2d 189, 192 (9th Cir. 1964), nondeductible expenditures included living expenses, payment of insurance premiums, fees paid to an attorney, bond premiums, and other nondeductible expenditures. Automobiles, antiques, and travel were added to the net worth increase as nondeductible expenditures in *United States v. Sorrentino*, 726 F.2d 876, 880 (1st Cir. 1984). Gifts, vacation trips, payments for a maid, and gifts for a spouse and third parties are further examples of nondeductible expenditures. *United States v. Goichman*, 407 F. Supp. 980, 989 (E.D. Pa.), *aff'd*, 547 F.2d 778 (3d Cir. 1976).

Where the government is unable to trace expenditures for household goods or services, personal entertainment, or personal care items, the jury can properly conclude that the defendant must have incurred some expenses for these items and that these expenses would have added to the defendant's net worth increase and expenditures, beyond what the government proved. *Scott*, 660 F.2d at 1151. Omitting personal expenditures for food and clothing does not permit the jury to improperly speculate as to the defendant's personal expenses. *United States v. Notch*, 939 F.2d 895, 900 (10th Cir. 1991). In *Notch*, the Tenth Circuit recognized that "[t]his conservative approach to the net worth computation made the analysis appear more credible" and can be viewed "as showing that the jury need not consider personal expenses in order to conclude that defendant understated his income." *Notch*, 939 F.2d at 900.

Note that there is a difference in the net worth treatment when living expenses are to be used in determining cash on hand in the opening net worth as opposed to expenditures for living expenses made in a prosecution year. When the purpose is to determine the opening cash on hand of the taxpayer, living expenses and other expenditures are subtracted from the available resources of the taxpayer in determining whether the taxpayer expended all or part of what might otherwise constitute cash on hand. When the purpose is to reflect the increase in wealth of the taxpayer, living expenses and

other nondeductible expenditures in a prosecution year are added to the net worth increase,.

31.11 **REDUCTIONS IN NET WORTH**

The purpose of the net worth computation is to arrive at taxable income, and the computation therefore must reflect taxable consequences. Therefore, nontaxable items received by the taxpayer during the prosecution period must be eliminated or accounted for in the net worth computation. The following types of nontaxable items must be subtracted from the total reflecting the net worth increase and nondeductible expenditures: gifts received, inheritances, nontaxable pensions, the nontaxable portion of capital gains, veterans benefits, dividend exclusions, tax-exempt interest, proceeds from life insurance, and any other nontaxable items.

An example of the treatment of such an item is found in *United States v. Holovachka*, 314 F.2d 345, 355 (7th Cir. 1963). In that case, the defendant had purchased bonds for investment purposes and received monies during the prosecution year representing the repayment of principal and nontaxable interest:

> Government treated the principal repayments as a tax free return of capital which correspondingly decreased defendant's investments in such bonds for those years. The yearly interest payments received on these bonds were considered to be tax free and were accordingly deducted from defendant's net worth. The trial court properly instructed the jury that the repayments of principal and the earned interest constituted non-taxable income.

Holovachka, 314 F.2d at 355.

Technical items and items that are clearly not fraudulent are also deducted from the taxpayer's computed net worth. Thus, the underreporting of an income item as the result of an inadvertent error of the defendant or his accountant should not be charged to the defendant. Any such item is subtracted, or otherwise accounted for, in arriving at taxable income.

In *United States v. Altruda*, 224 F.2d 935, 940 (2d Cir. 1955), the defendant's accountant explained to the examining agent prior to trial that the defendant had made "errors" in underreporting income from realty holdings, and the defendant was given credit for these amounts in the government's net worth computation. In *United States v. Allen*, 522 F.2d 1229, 1231 (6th Cir. 1976), a technical adjustment was made, reducing the net worth computation to allow for an error discovered in one of the adding machine tapes used in preparing the defendant's return. The net effect was that the adjustment allowed the entire deduction claimed by the defendant on his return, and the defendant was not charged with the error in the net worth computation.

31.12 **ATTRIBUTING NET WORTH INCREASES TO TAXABLE INCOME**

31.12[1] **Generally**

The net worth method of proof requires evidence supporting "the inference that the defendant's net worth increases are attributable to currently taxable income." *Holland v. United States*, 348 U.S. 121, 137 (1954); *United States v. Dwoskin*, 644 F.2d 418, 422 (5th Cir. 1981); *United States v. Hom Ming Dong*, 436 F.2d 1237, 1241 (9th Cir. 1971); *United States v. Mackey*, 345 F.2d 499, 506 (7th Cir. 1965); . Increases in net worth, standing alone, cannot be assumed to be attributable to currently taxable income.

There are two ways of supporting an inference that net worth increases are attributable to currently taxable income:

1. Proof of a likely source of taxable income. *Holland*, 348 U.S. at 137-38.

2. Negating non-taxable sources of income. *United States v. Massei*, 355 U.S. 595 (1958).

Either method is sufficient. *See also United States v. Sorrentino*, 726 F.2d 876, 879-80 (1st Cir. 1984); *United States v. Scott*, 660 F.2d 1145, 1151 (7th Cir. 1981); *Dwoskin*, 644 F.2d at 422; *United States v. Grasso*, 629 F.2d 805, 807-08 (2d Cir. 1980); *United States v. Hiett*, 581 F.2d 1199, 1201 (5th Cir. 1978).

31.12[2] **Proof of Likely Source of Taxable Income**

The government can establish a likely source of taxable income through direct or circumstantial evidence. The applicable rule requires "proof of a likely source, from which the jury could reasonably find that the net worth increases sprang." *Holland v. United States*, 348 U.S. 121, 138 (1954). It is not necessary for the government to prove by direct evidence that the unreported income reflected by the net worth computation, in fact, came from the likely source established. *United States v. Mackey*, 345 F.2d 499, 506-07 (7th Cir. 1965). *See also United States v. Smith*, 890 F.2d 711, 714 (5th Cir. 1989) (likely source of income could be indicated by business operations, mineral interests, real estate, stocks, bonds, commodities, and gambling); *United States v. Greene*, 698 F.2d 1364, 1373 (9th Cir. 1983) (the government need not prove a specific source, but only a likely source, and evidence established real estate sales, interest income on loans, and unreported securities transactions as likely sources of taxable income); *United States v. Hom Ming Dong*, 436 F.2d 1237, 1241-42 (9th Cir. 1971) (grocery store ownership provided likely source); *United States v. Costello*, 221 F.2d 668, 671-72 (2d Cir.), *aff'd*, 350 U.S. 359 (1956) (the evidence established that the defendant was a gambler and "gambling is an occupation with indeterminate possibilities").

Likewise, the government does not have to show that the likely source was capable of generating the entire amount of unreported income charged in the indictment. *United States v. Costanzo*, 581 F.2d 28, 33 (2d Cir. 1978). The court found that extensive proof supported the inference that the defendant's bakery was a likely source of unreported taxable income because the bakery was large enough to generate substantial amounts of unreported cash receipts. *Costanzo*, 581 F.2d at 33. Evidence of specific items of unreported income is admissible to show a likely source from which the net worth increases may have come. *Holland*, 348 U.S. at 138; *United States v. Schafer*, 580 F.2d 774, 777 n.5 (5th Cir. 1978). *See also United States v. Hagen*, 470 F.2d 110, 111 (10th Cir. 1972), in which the defendant claimed surprise and argued that the government introduced evidence as to specific items of unreported income to an extent that the specific items proof "changed the theory of the case or in any event overshadowed the net worth proof." The court noted that the specific items evidence assumed such a large role at the trial that "at the end it became difficult to say whether it still was a net worth case." *Hagen*, 470 F.2d at 112. But the court continued:

> In any event the Government followed and met the requirements of *Holland v. United States*. The evidence of specific items was proper as indicated to show wilfulness, but it was also proper to show a likely source under *Smith v. United States*, 348 U.S. 147, 75 S.Ct. 194, 99 L.Ed. 192 and *United States v. Calderon*, 348 U.S. 160, 75 S.Ct. 186, 99 L.Ed. 202.

470 F.2d at 113.

In a situation such as that in *Hagen*, problems as to the government's method of proof can be avoided by clearly designating in a response to a motion for a bill of particulars the method of proof to be

relied upon by the government, such as, net worth method and specific items method, or net worth method corroborated by specific items of unreported income.

Once the government has introduced evidence of a likely source of taxable income, the government has no burden to negate all possible nontaxable sources of the unreported income. While the government does have a duty to check out reasonable leads, when the defendant furnishes no leads, "the Government is not required to negate every possible source of nontaxable income, a matter peculiarly within the knowledge of the defendant." *Holland v. United States*, 348 U.S. 121, 138 (1954). Caution must be exercised in following this principle, however, because the government has an obligation in net worth cases to conduct a thorough investigation, which would include searching for nontaxable sources of income.

Once a likely source is established, the government does not have to show that it has investigated "the many possible nontaxable sources of income, each of which is as unlikely as it is difficult to disprove." *Holland*, 348 U.S. at 138. The government is not limited to showing a single likely source of taxable income but can introduce evidence of as many possible sources of taxable income as the investigation has developed. *See*, *e.g.*, *Feichtmeir v. United States*, 389 F.2d 498, 502 (9th Cir. 1968) (evidence showed the defendant had interests in eight operating businesses, investments in real estate, a trust deed, a joint venture, stocks and bonds, and an undisclosed Mexican source of income).

31.12[3] **Illegal Sources of Income**

There is no requirement that the likely source of income be a legal source. *James v. United States*, 366 U.S. 213 (1961). "[G]ross income means all income from whatever source derived . . . ." 26 U.S.C. § 61.

Due to the possibility of undue prejudice, courts closely examine evidence of an illegal source of income. *See*, *e.g.*, *United States v. Tunnell*, 481 F.2d 149, 151 (5th Cir. 1973) (likely source of the defendant's net worth increases could have been income from prostitution activities at a motel the defendant operated). When the likely source of income is illegal, the evidence must present more than suspicion and innuendo. *See Ford v. United States*, 210 F.2d 313, 317 (5th Cir. 1954) (reversing a police chief's tax evasion conviction because testimony as to payoffs by prostitutes was not connected to the defendant). *But see United States v. Windham*, 489 F.2d 1389, 1391 (5th Cir. 1974) (stating that *Ford* conviction was reversed because of the speculative, hearsay nature of the testimony, not because of its content).

Likewise, it must be clear that the purpose of introducing evidence of illegal activities is to establish a likely source of income, and the evidence must not be introduced or alluded to in a manner calculated to inflame the jury. In *United States v. Abodeely*, 801 F.2d 1020 (8th Cir. 1986), the government presented evidence that the defendant derived his unreported income from illegal prostitution and from legal gambling activities. After a lengthy discussion of the Rule 403 probative/prejudice balancing test, the court concluded that it had:

> [N]o conceptual difficulty with the evidence concerning prostitution. While it is certainly prejudicial, it is highly probative of unreported taxable income. The gambling evidence, while having less direct probative value, is much less prejudicial, and indeed if its admission was error (which this court does not conclude), the error was harmless beyond a reasonable doubt. After all, having been shown that Abodeely ran a bar and a brothel, even the most straitlaced Iowa jury would hardly have been adversely affected by a showing of his participation in the legal, though perhaps sinful and worldly in the eyes of a midwestern jury, activity of gambling in Nevada.

Abodeely, 801 F.2d at 1026. *See also United States v. Smith*, 890 F.2d 771, 716 (5th Cir. 1989) (defendant not prejudiced by introduction of evidence concerning his gambling activities); *United States v. Tafoya*, 757 F.2d 1522, 1526-28 (5th Cir. 1985) (income from payments for attempted assassinations; bank deposits case); *United States v. Vannelli*, 595 F.2d 402, 405-06 (8th Cir. 1979) (evidence of defendant's prior misdemeanor convictions of misappropriation of funds held admissible to show intent, opportunity, scheme, or plan from which unreported income could be derived and to show potential source of unreported income; bank deposits case); *Windham*, 489 F.2d at 1391;. The illegal sources for generating income are virtually limitless. *See United States v. Dall*, 918 F.2d 52 (8th Cir. 1990) (illegal importation of veterinary drugs); *Clinkscale v. United States*, 729 F.2d 940, 942 (8th Cir. 1984) (prostitutes turned over income to defendant, which he failed to report); *United States v. Chapman*, 168 F.2d 997, 1000-01 (7th Cir. 1948) (black market sales of meat likely source of income).

Skimming is another example of a likely source of taxable income which a jury could conclude accounts for the defendant's increase in net worth. *See United States v. Koskerides*, 877 F.2d 1129, 1138 (2d Cir. 1989) (two diners operated as cash businesses may be likely source of unreported income where previous owner had much higher revenue than defendant and testimony indicated the possibility of skimming); *United States v. Sorrentino*, 726 F.2d 876, 880 (1st Cir. 1984); *United States v. Hamilton*, 620 F.2d 712, 715 (9th Cir. 1980) (jury could have found that the likely source of taxable funds was the illegal diversion of money from slot machine revenues); [FN4] .

Drug sales frequently provide a possible source of income. *See United States v. Scrima*, 819 F.2d 996, 999 (11th Cir. 1987); *United States v. Palmer*, 809 F.2d 1504, 1505 (11th Cir. 1987); *United States v. Lewis*, 759 F.2d 1316, 1328, 1336 (8th Cir. 1985); *United States v. Horvath*, 731 F.2d 557, 563 (8th Cir. 1984); *United States v. Heyward*, 729 F.2d 297 (4th Cir. 1984); [FN5] *United States v. Enstam*, 622 F.2d 857, 860 (5th Cir. 1980); *United States v. Browning*, 723 F.2d 1544, 1547 (11th Cir. 1984).

The government should make sure that the jury instructions make it clear that the defendant is on trial for tax evasion and for no other crimes. *See Windham*, 489 F.2d at 1389 (commenting that this was done in *United States v. Tunnell*, 481 F.2d 149 (5th Cir. 1973)). Limiting instructions are also advisable. *Palmer*, 809 F.2d at 1505 (11th Cir. 1987) (trial court properly maintained jury's focus on tax issues and properly minimized any possible prejudice by giving clear limiting and final instructions).

31.12[4] **Negating Nontaxable Sources of Income**

It is well established that "[s]hould all possible sources of nontaxable income be negated, there would be no necessity for proof of a likely source." *United States v. Massei*, 355 U.S. 595 (1958). The Fifth Circuit summarized the government's burden where the defendant has failed to provide any leads as to nontaxable sources of income:

> We therefore hold that in an income tax evasion case based on the net worth method of proof, when the taxpayer gives no leads as to nontaxable sources, the government satisfies its burden of negating all possible nontaxable sources within the meaning of *Massei* by showing that it conducted a thorough investigation that failed to reveal any nontaxable source.

United States v. Hiett, 581 F.2d 1199, 1202 (5th Cir. 1978). In response to the defendant's argument that the government must negate every possible source of nontaxable income, the court in *Hiett* noted that this would be an impossible task because:

> [It] would require the government to exhaust the inexhaustible -- to conduct an absolutely limitless investigation. It would cast the government in the role of a conjurer, forcing it to pull nontaxable sources out of a hat. Appellant would require the government to embark on a Magellan-like expedition in order to prove that the unreported income was taxable. Not only would the Government have to circle the globe in its search, it would also have extraorbital responsibility, since appellant's position requires it to prove a cosmic negative. To state appellant's position is to establish its absurdity. If *Massei* and *Holland* are to have viability in our jurisprudence, they cannot be read to sanction such a result.

Hiett, 581 F.2d at 1201. *Accord United States v. Notch*, 939 F.2d 895 (10th Cir. 1991); *United States v. Schipani*, 362 F.2d 825, 830 (2d Cir.), *vacated and remanded on other grounds*, 385 U.S. 372 (1966) (government can meet its burden under *United States v. Massei*, by negating all *reasonably* possible sources of nontaxable income). The investigating agent may testify that his investigation failed to uncover any sources of nontaxable income. *United States v. Dwoskin*, 644 F.2d 418, 423 (5th Cir. 1981); *United States v. Penosi*, 452 F.2d 217, 219 (5th Cir. 1971).

In short, it is sufficient if the government's evidence establishes that there was a thorough investigation, "which removes any reasonable doubt that the defendant's unreported income came from non-taxable sources." *United States v. Hiett*, 581 F.2d 1199, 1202 (5th Cir. 1978). *See also United States v. Smith*, 890 F.2d 711, 714 (5th Cir. 1989). [FN6]

31.13 **REASONABLE LEADS DOCTRINE**

31.13[1] **Duty to Investigate Reasonable Leads**

Taxpayers frequently give the government's agents leads indicating the specific sources from which claimed cash on hand was derived, such as prior earnings, stock transactions, real estate profits, inheritances, gifts, etc. *Holland v. United States*, 348 U.S. 121, 127 (1954). The *Holland* reasonable leads doctrine places on the government the duty of "effective negation of reasonable explanations by the taxpayer inconsistent with guilt" -- a duty limited to the investigation of "leads reasonably susceptible of being checked, which, if true, would establish the taxpayer's innocence." *Holland*, 348 U.S. at 135-36.

Thus, the government's duty to investigate leads provided by the taxpayer hinges on the presence of two factors: (1) the taxpayer's explanation must be relevant and reasonable; and (2) the explanation must be reasonably susceptible of being checked. *Holland*, 348 U.S. at 135-36; *United States v. Anderson*, 642 F.2d 281, 285 (9th Cir. 1981) (loan from acquaintance in Nigeria not a reasonable lead and not reasonably susceptible of being checked).

The government meets its burden when it "investigates reasonably possible sources of non-taxable income, and explores whatever leads the taxpayers or others may proffer." *United States v. Mastropieri*, 685 F.2d 776, 785 (2d Cir. 1982). The government is not required to do the impossible. *United States v. Greene*, 698 F.2d 1364, 1371 (9th Cir. 1983). Once the government establishes a prima facie case, the taxpayer "remains quiet at his peril." *Mastropieri*, 685 F.2d at 785. *Accord United States v. Goldstein*, 685 F.2d 179, 182 (7th Cir.1982) (information on nontaxable income should be supplied by the taxpayer). Although the burden of proof never shifts from the government, the defendant has the *burden of production* regarding any reasonable leads. *United States v. Vardine*, 305 F.2d 60, 63 (2d Cir. 1962). It is up to the taxpayer to furnish the reasonable leads. *United States v. Notch*, 939 F.2d 895, 899 (10th Cir. 1991); *United States v. Caswell*, 825 F.2d 1228, 1234 (8th Cir. 1987);. The government is not

required to pursue "phantom clues as to some mysterious sources and assets." *United States v. Hamilton*, 620 F.2d 712, 715 (9th Cir. 1980).

For cases in which the court found that the defendant's explanations were not reasonable or reasonably capable of being checked, *see United States v. Londe*, 587 F.2d 18, 20 (8th Cir. 1978) (lead found to be completely lacking in credibility and did not warrant follow-up beyond the production of the individual as a government witness, which did occur); *United States v. Potts*, 459 F.2d 412, 414 (7th Cir. 1972) (the government's failure to investigate leads from witnesses whose credibility was tenuous did not require a reversal); *United States v. Hom Ming Dong*, 436 F.2d 1237, 1242-43 (9th Cir. 1971) (when leads are "sketchy" and the defendant furnishes little useful information, there is less of a burden on the government); *United States v. Ford*, 237 F.2d 57, 64 (2d Cir. 1956), *vacated as moot*, 355 U.S. 38 (1957) (claims of gifts so vague that they were not susceptible of further investigation); *Smith v. United States*, 236 F.2d 260, 267 (8th Cir. 1956) (explanation that his funds came from old mailbags and old iron pots not reasonably susceptible of being checked).

Moreover, there is "at least a minimal burden upon the taxpayer, once he chooses to furnish leads to the government, to aid in the investigation of the purported nontaxable source." *Hom Ming Dong*, 436 F.2d at 1242-43. *See United States v. Terrell*, 754 F.2d 1139, 1146 (5th Cir. 1985) (taxpayer has a burden to furnish leads, and the government cannot be faulted for failure to identify any possible basis in cattle where the government was diligent in following up on all leads relating to the cattle, despite the fact that defendant was uncooperative in providing leads); *United States v. Blandina*, 895 F.2d 293, 302-03 (7th Cir. 1989) (scope of government's investigation of reasonable leads does not require government to subpoena records which defendant refused to turn over).

For examples of adequate government investigation of taxpayer leads which were susceptible to investigation, *see United States v. Smith*, 890 F.2d 711, 714-15 (5th Cir. 1989) (court rejected a "reasonable leads" challenge regarding gifts to the defendant); *United States v. Koskerides*, 877 F.2d 1129 (2d. Cir. 1989) (government negated defendant's claim that he had received non-taxable funds from family and friends in Greece).

In situations where a taxpayer furnishes leads which might reasonably explain his net worth bulge in a manner inconsistent with guilt and the government fails to investigate these leads, the trial judge should consider the taxpayer's explanations as true. *Vardine*, 305 F.2d at 63. However, when the defendant advances a specific explanation of the source of funds expended and that explanation is proved false, the government need not pursue possible nontaxable sources. *Feichtmeier v. United States*, 389 F.2d 498, 503 (9th Cir. 1968); *United States v. Holovachka*, 314 F.2d 345, 357 (7th Cir. 1963).

Failure of the government to investigate reasonable leads provided by the defendant can result in a severe remedy. The trial judge can consider such leads as true and find the case insufficient to go to the jury. *Holland*, 348 U.S. at 135. The court can direct a verdict on any count where there would not be a substantial tax deficiency if the lead is assumed to be true. *United States v. Keller*, 523 F.2d 1009, 1011 (9th Cir. 1975) (because the government failed to pursue leads which were reasonably susceptible of being checked, the opening net worth for 1967 was not reasonably certain and the evidence as to the 1967 count was insufficient to go to the jury).

The failure to track down reasonable leads, however, is not always fatal to the government's case. If the uninvestigated lead is assumed to be true and there remains a substantial, unexplained tax deficiency, then reversal of a conviction (or a directed verdict) is not warranted. *See Scanlon v. United States*, 223 F.2d 382, 388-89 (1st Cir. 1955) (government's failure to investigate this lead would require acquittal

of the defendant if the government's case turned on that evidence but even assuming this lead to be true, the government's evidence was sufficient to convict); *Anderson*, 642 F.2d at 285 (9th Cir. 1981) (even if the defendant's explanation were true, there would be more than $100,000 of unexplained income, and this difference would be sufficient to support the conviction).

At least one circuit has held that, if there is a challenge to the sufficiency of the government's investigation, it becomes a jury question whether or not the government was unreasonable in its failure to investigate alleged leads. *Greene*, 698 F.2d at 1371.

The government's failure to investigate leads by the defendant has also been challenged unsuccessfully in the grand jury context. One court refused to dismiss an indictment, finding the defendant's contention that the government failed to exhaust leads during the grand jury investigation insufficient to warrant dismissal of the indictment. *United States v. Todaro*, 610 F. Supp. 923, 925 (W.D.N.Y. 1985). In *Todaro*, the court held that the pre-trial motion to dismiss was premature because this was a matter for trial, citing *Holland*, 348 U.S. 121, and *United States v. Scott*, 660 F.2d 1145, 1167 n.42 (7th Cir. 1981).

31.13[2] **Leads Must Be Reasonable and Timely**

In addition to furnishing leads that are reasonable and reasonably susceptible of being checked, the taxpayer must furnish any leads in a timely manner. Therefore, leads must be provided to the government a sufficient amount of time before trial to permit investigation. *United States v. Sorrentino*, 726 F.2d 876, 881 n.2 (1st Cir. 1984). Where there is no evidence that the defendant gave leads to the government before trial and the defendant testifies at trial that the net worth increase was due to the receipt of nontaxable income, the issue is one for the jury. *United States v. Vardine*, 305 F.2d 60, 65 (2d Cir. 1962).

The underlying principle is that "the taxpayer has a burden to furnish 'leads'. . . so that the government can investigate and perhaps clear the taxpayer prior to trial." *United States v. Schafer*, 580 F.2d 774, 779 (5th Cir. 1978). *See United States v. Terrell*, 754 F.2d 1139, 1146 (5th Cir. 1985). *See United States v. Dwoskin*, 644 F.2d 418, 423 n.4 (5th Cir. 1981) (had leads been provided during the investigative process, the government would have had an obligation to pursue them to the extent that they were relevant and reasonably susceptible of being checked).

In short, leads must be furnished well in advance of trial. *Smith v. United States*, 236 F.2d 260, 263-64 (8th Cir. 1956). A lead furnished "on the eve of indictment" is too late. *United States v. Procario*, 356 F.2d 614, 617 (2d Cir. 1966) (a bank deposits case, but the same principle applies in a net worth case).

31.14 **NET WORTH SCHEDULES**

At the close of its case, the government typically calls a summary expert witness who summarizes the evidence and introduces schedules reflecting the government's net worth computation. It is well established that a government agent can summarize the evidence and introduce into evidence computations and schedules reflecting the defendant's net worth. *Costello v. United States*, 350 U.S. 359 (1956); *United States v. Johnson*, 319 U.S. 503, 519 (1943); *United States v. Lewis*, 759 F.2d 1316, 1329 n.6 (8th Cir. 1985) (summary exhibit used to verify the net worth theory); *United States v. Sorrentino*, 726 F.2d 876, 884 (1st Cir. 1984); *United States v. Skalicky*, 615 F.2d 1117, 1120 (5th Cir. 1980); *United States v. Gardner*, 611 F.2d 770, 776 (9th Cir. 1980); *United States v. Allen*, 522 F.2d 1229, 1234 (6th Cir. 1975); *United States v. O'Connor*, 237 F.2d 466, 475 (2d Cir. 1956); Fed. R.

Evid. Rule 1006.

The net worth schedules must be based upon evidence in the record; otherwise, the schedules are not admissible. *See*, *e.g.*, *Sorrentino*, 726 F.2d at 884; *Allen*, 522 F.2d at 1234; *United States v. Diez*, 515 F.2d 892, 905 (5th Cir. 1975); *O'Connor*, 237 F.2d at 475; *see also United States v. Citron*, 783 F.2d 307, 316 (2d Cir. 1986) (cash expenditures method).

The government's net worth computation is not required to give effect to contentions of the defendant. Rather, the government's summary or net worth computation is based on a selection of that evidence which supports the government's contentions. It is a summary of evidence tending to prove guilt, and it reflects the government's version of the facts. *United States v. Diez*, 515 F.2d at 905; *United States v. Lawhon*, 499 F.2d 352, 357 (5th Cir. 1974) (jury was instructed that the summary chart presented only the government's view of the case); *Holland v. United States*, 209 F.2d 516, 523-24 (10th Cir.), *aff'd*, 348 U.S. 121 (1954) (charts purporting to graphically show the government's case based upon the government's version of the evidence used in closing argument to the jury).

Essentially, the government's net worth computation is not intended to be a summary of all of the evidence introduced by the government. Nor does the summary purport to include theories of the defense brought out either on the direct or cross-examination of a government witness. As a matter of tactics, however, there are situations where the evidence is in conflict and the government computation will reflect the view that is more favorable to the defendant, *i.e.*, not all evidence favorable to the defendant should necessarily be disregarded.

Note the distinction made in *Flemister v. United States*, 260 F.2d 513, 517 (5th Cir. 1958), in which the court observed that a government summary need not give effect to the contentions of the accused, but if the summary purports to be a statement of all of the evidence then it must be a summary of all of the evidence. The summary must be what it purports to be. In *Flemister*, the court found that the government summaries failed to show that they represented only the testimony of government witnesses and were not a summary of all of the relevant testimony. *Flemister*, 260 F.2d at 517. To avoid this problem, the agent should testify clearly that the government's net worth computation is a summary only of government contentions and not a summary of all of the evidence in the record.

31.15 **JURY INSTRUCTIONS**

In a net worth case, detailed, comprehensive jury instructions on the method of proof are essential. "Charges should be especially clear, including, in addition to the formal instructions, a summary of the nature of the net worth method, the assumptions on which it rests, and the inferences available both for and against the accused." *Holland v. United States*, 348 U.S. 121, 129 (1954); *United States v. Carter*, 721 F.2d 1514, 1538 (11th Cir. 1984); *United States v. Wirsing*, 719 F.2d 859, 861-62 n.4 (6th Cir. 1983).

Convictions have been reversed when the trial judge failed to give full explanatory instructions on the net worth method. *United States v. Hall*, 650 F.2d 994, 999 (9th Cir. 1981); *United States v. Tolbert*, 367 F.2d 778, 781 (7th Cir. 1966); *United States v. O'Connor*, 237 F.2d 466, 472 (2d Cir. 1956). "[T]he complete lack of any instruction on the nature of the [net worth] method and its concomitant assumptions and inferences affects a substantial right of the accused and constitutes plain error. . . and requires a reversal despite the lack of an objection by the defendant to such omission." *Tolbert*, 367 F.2d at 781.

For a sample net worth jury instruction, *see* the section on

jury instructions, *infra*.

31.16 **SAMPLE NET WORTH SCHEDULE**

On the next page is a reproduction of the net worth computation admitted into evidence in *United States v. Carter*, 462 F.2d 1252, 1253 (6th Cir. 1972).

RUSSELL L. CARTER
Computation of Unreported Taxable Income Based On
Net Worth and Personal Living Expenses

ASSETS	12-31 1962	12-31 1963	12-31 1964	12-31 1965
Cash on Hand	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00
Cash in Banks				
Checking Accounts	2,556.79	167.56	356.06	264.57
Bonds -- Series E	90,897.58	121,770.04	122,001.00	131,601.17
Stocks and Notes Receivable	2,983.72	1,983.72	983.72	13,487.50
Real Estate	9,386.92	9,386.92	9,386.92	51,886.92
Business Equipment	5,700.00	5,700.00	5,700.00	5,700.00
Automobiles	9,428.49	4,950.00	6,854.70	8,554.70
TOTAL ASSETS	$136,953.50	$159,958.24	$176,282.40	$242,494.86
LIABILITIES				
Mortgages and Loans Payable	$ 402.88	$ 49.93	$ -0-	$ 22,260.00
Allowance for Depreciation	7,059.11	5,105.90	4,089.00	6,040.85
TOTAL LIABILITIES	$ 7,461.99	$ 5,155.83	$ 4,089.00	$ 28,300.85
NET WORTH	$129,491.51	$154,802.41	$172,193.40	$214,194.01
Beginning Net Worth		(129,491.51)	(154,802.41)	(172,193.40)
Increase in Net Worth		$ 25,310.90	$ 17,390.99	$ 42,000.61
Personal Living Expenses		12,646.61	22,303.34	16,283.63
Adjustments to Net Worth		(1,144.97)	(861.14)	(1,039.21)
Adjusted Gross Income		$ 36,182.54	$ 38,833.19	$ 57,245.03
Deductions		(2,394.66)	(2,461.99)	(3,738.75)
Exemptions		(2,400.00)	(2,400.00)	(2,400.00)

Taxable Income			
Corrected	$ 32,017.88	$ 33,971.20	$ 51,106.28
Taxable Income Reported	(7,527.33)	(18,765.49)	(9,610.33)
Unreported Taxable Income	$ 24,490.55	$ 15,205.71	$ 41,495.95

FN 1. The defendant contended that the use of the net worth method was not proper because the government did not make the necessary preliminary proof that (1) the taxpayer had no books; or (2) refused to produce them; or (3) the books did not clearly reflect his income; and (4) the circumstances were such that the net worth method did reflect his income with reasonable accuracy and certainty. *McGrew v. United States*, 222 F.2d 458, 459 (5th Cir. 1955).

FN 2. As an evidentiary matter, the *Mastropieri* court criticized the fact that the record did not contain the "form of letter or letters" which the special agent sent to the banks, brokerage firms, and lending institutions that he canvassed as a part of the investigation. *Mastropieri*, 685 F.2d at 779 n.3. This concern suggests that care should be taken in drafting such letters, because they may be used later to demonstrate the effort made to locate the defendant's assets and liabilities.

FN 3. Where corroboration is required, the jury should be instructed on that requirement. *See United States v. Marshall*, 863 F.2d 1285, 1288 (6th Cir. 1988) (reversing a jury verdict because the jury was not instructed that a defendant's extrajudicial statements must be corroborated with independent evidence).

FN 4. It is interesting to note that in *Hamilton*, 620 F.2d 712 (9th Cir. 1980), the court upheld as admissible, and found most convincing, the testimony of a statistical expert who had examined the slot machines, reviewed their reported performance, compared their performance with similar machines at other casinos and with the manufacturer's built-in specifications, and concluded that the odds against the machine performing as poorly as the records indicated were greater than two billion to one. *Hamilton*, 620 F.2d at 715.

FN 5. This case is of particular interest because the court admitted evidence that the defendant's plane was found in Georgia in 1980 loaded with over 4,000 pounds of marijuana and the prosecution years were 1978 and 1979.

FN 6. The Second Circuit suggested that in rare situations less stringent standards might apply with respect to both establishing opening net worth and to negating nontaxable income sources. These standards "are justified in a case like this where defendants were shown to have gone to such lengths to conceal their unreported increases in wealth." *United States v. Mastropieri*, 685 F.2d 776, 785 (2d Cir. 1982).