TAXATION OF DRUG TRAFFICKERS' INCOME: WHAT THE DRUG TRAFFICKER PROFITETH, THE IRS TAKETH AWAY

Elizabeth M. Rutherford, C.P.A.

INTRODUCTION

The scene could be part of any prime time detective television show. A "businessman" has all the indices of wealth — expensive airplanes, palatial residences, and fast cars. Yet he has no apparent source of legitimate income, which may be the reason this businessman does not file income tax returns. The action scene occurs when one of his customers, an undercover Drug Enforcement Administration (DEA) agent, arrests him for possession and sale of controlled substances. The final scene shows the convicted drug dealer behind bars.

But a conviction and a prison sentence for drug trafficking do not realistically constitute the final scene for these criminals. The drug trafficker is likely to get a visitor in jail — an Internal Revenue Service (IRS) agent.[1] The IRS understandably takes a keen interest in substantial unreported income.[2]

IRS investigations of drug traffickers are becoming increasingly commonplace, due to the sheer magnitude of the national drug problem. The U.S. Department of State Bureau of Public Affairs estimates that U.S. citizens consume sixty-five percent of the world's narcotics supply.[3] The illicit drug market's gross sales are currently valued from $60 billion to $150 billion annually.[4] The illegal drug trade is also very profitable at all production and distri-

---

1. An IRS investigation can come before or after a conviction. In addition, law enforcement agencies are diligent in reporting convicted or suspected drug traffickers to the IRS. *See, e.g.*, Curtis v. Commissioner, 59 T.C.M. (CCH) 548, 550 (1990), *aff'd*, No. 90-1954 (1st Cir. May 13, 1991) (taxpayer notified of tax liability six months after pleading guilty to drug charges); Kingsley v. Commissioner, 58 T.C.M. (CCH) 1428, 1431-32 (1990) (tip from Assistant United States Attorney initiated tax investigation four months after taxpayer indicted on drug charges); Graff v. Commissioner, 52 T.C.M. (CCH) 1025, 1027 (1986) (Los Angeles Police Department detectives contacted IRS agent shortly after they arrested taxpayer); Estate of Gary v. Commissioner, 35 T.C.M. (CCH) 820 (1976) (city police informed IRS three days after searching taxpayer's apartment and seizing cash and heroin).

2. Income from illegal sources is taxable for obvious policy reasons. *See infra* note 15 and accompanying text.

3. Teasley, *Extent of the Problem*, Cong. Res. Serv. Rev. 5 (Nov.-Dec. 1989).

4. *Id.* The author did not specify whether he valued the illicit drug market at wholesale or retail prices. In any event, these figures are understandably difficult to substantiate. To put these values in perspective, an illegal drug market totalling $150 billion annually out-dis-

bution levels.[5]

The federal government has taken a combative approach to the domestic narcotics problem. Recent legislation includes the Comprehensive Crime Control Act of 1984,[6] the Anti-Drug Abuse Act of 1986,[7] and the Anti-Drug Abuse Act of 1988.[8] These statutes represent a comprehensive approach to the nation's narcotics problem, including stricter sentencing provisions, rehabilitation programs, and money-laundering proscriptions.[9]

The IRS's involvement in the war on drugs has been more subtle. The Service utilizes income reconstruction techniques to compute drug traffickers' taxable income.[10] This calculation determines the drug trafficker's tax liability, upon which civil[11] and criminal[12] penalties are assessed.

This Note explores the comprehensive approach the IRS takes in investigating and taxing drug traffickers. It first addresses the statutory framework that allocates responsibility between the IRS and the taxpayer in tax investigations. This includes procedural tools that help the IRS expedite tax collection. Additionally, the IRS increases the drug trafficker's tax liability with penalties and additions to tax. This section provides a background to the structure in which the IRS operates.

Next, this Note explores income reconstruction. This section examines burden of proof issues, including presumptions and burden-shifting between the taxpayer and the government. The section also explains reconstruction techniques, such as the net worth, cash expenditures, specific item, and bank deposits methods. The analysis focuses on each method's importance and usefulness in drug investigations.

Lastly, this Note presents an example of the financial impact of a tax investigation upon the drug trafficker. This is important because, although the IRS works in the background of drug investigations, its ability to employ such investigative techniques provides the federal government with a significant

---

tances American spending on tobacco ($37 billion) and alcoholic beverages ($62 billion) combined. Molefsky, *Economics of Drug Trafficking*, Cong. Res. Serv. Rev. 9 (Nov.-Dec. 1989).

5. *See* Molefsky, *supra* note 4, at 10. The *Wall Street Journal* estimates refiners earn 66% profit, distributors earn 63% profit, and dealers earn 31% profit. *Id.*

6. Pub. L. No. 98-473, 98 Stat. 2049 (1984) (codified as amended in scattered sections of 21 U.S.C.) (investment of illicit drug profits punishable by fine or imprisonment; includes provision for forfeiture of assets).

7. Pub. L. No. 99-570, 100 Stat. 3207 (1986) (codified as amended primarily in scattered sections of 21 U.S.C.) (containing numerous provisions dealing with penalties, enforcement, asset forfeiture, money laundering, state and local narcotic control assistance, and federal policy).

8. Pub. L. No. 100-690, 102 Stat. 4181 (1988) (codified as amended in scattered sections of 21 U.S.C. and 42 U.S.C.). *See infra* note 9 for specific provisions of the Act.

9. The Anti-Drug Abuse Act of 1988 is a good example of the federal government's ambitious efforts to curb drug trafficking and drug abuse. Its provisions include stiffer jail sentences for drug traffickers, creation of the Office of National Drug Control Policy for centralizing drug control efforts, inducements to reduce demand for illegal drugs, and increased preventive measures and treatment for current drug users. *Id.*

10. *See infra* text accompanying notes 127-32. Also, many burden-shifting principles within income reconstruction have been adapted to suit the narcotics industry. *See infra* text accompanying notes 168-94.

11. *See infra* notes 58-107 and accompanying text.

12. *See infra* notes 108-26 and accompanying text.

source of funds. The results of this work are far-reaching: taxes from drug profits can be reinvested in government programs that help stem illegal use of drugs in the United States.

STATUTORY FRAMEWORK

All taxpayers have duties regarding the reporting of their tax liability. If the IRS believes that the taxpayer has fallen short of these statutory duties, it has many tools that help the Service compute and collect the tax liability, as well as penalize the taxpayer.

The Taxpayers' Responsibilities

Taxpayers have a number of statutorily mandated duties regarding their tax liability. Each taxpayer must be able to compute his taxable income,[13] upon which his tax liability is calculated.[14] Taxable income includes income from illegal sources,[15] and most taxpayers must report such income on their tax return.[16]

Furthermore, all taxpayers must maintain records that substantiate their tax liabilities.[17] The IRS does not mandate a specific format for keeping records,[18] so long as the records are accurate.[19] To supplement the accounting records, taxpayers must keep copies of any return, schedule, statement, or other document that the regulations or specific tax forms require.[20]

---

13. "Taxable income" is defined as gross income less certain deductions. I.R.C. § 63(a) (1986). "Gross income" is defined as "all income from *whatever source derived.*" I.R.C. § 61(a) (1986) (emphasis added).

14. I.R.C. §§ 1, 3 (1986).

15. Treas. Reg. § 1.61-14(a) (as amended in 1965); James v. United States, 366 U.S. 213, 219-20 (1961) (embezzled funds are included in gross income of embezzler for federal income tax purposes in year that the funds were misappropriated). Reporting such income can raise fifth amendment self-incrimination issues. *See* United States v. Sullivan, 274 U.S. 259 (1927) (fifth amendment does not protect recipient of illicit income from prosecution for willful refusal to file an income tax return).

16. *See* I.R.C. § 6012 (1986). Taxpayers beneath a certain level of income are generally exempt from this rule. *See* I.R.C. § 6012(a) (1986) (persons required to file income tax returns); I.R.C. § 151 (1986) (personal exemptions); I.R.C. § 63(c) (1986) (standard deduction).

17. I.R.C. § 6001 (1986). Most persons and entities are required to keep permanent accounting books, including inventories, which establish gross income, deductions, credits and any other information required to be shown on the tax return. Treas. Reg. § 1.6001-1(a) (as amended in 1978). Individuals who derive income mainly from salaries, wages or similar compensation for personal services do not need to keep detailed records, so long as the IRS can determine the correct amount of tax liability from other records. Treas. Reg. § 1.6001-1(b) (as amended in 1978). These records presumably are year-end reporting statements such as Form W-2 (wage and tax statement).

18. Treas. Reg. § 31.6001-1(a) (1991).

19. "Accurate" means that the taxpayer's accounting system and records enable the IRS to determine the taxpayer's liability. *Id.*

20. Treas. Reg. § 31.6001-1(b) (1991). The IRS recommends that the average taxpayer keep invoices, receipts, cancelled checks, stock brokerage statements, Form W-2s (wage and tax statements), Form 1099s (statement for recipients of miscellaneous income) and any other documents needed to prove any income, deduction, or tax credit items. I.R.S. PUB. NO. 552 (rev. Nov. 1988).

Most drug traffickers have nonexistent or incomplete records.[21] The illegal nature of the drug business encourages the drug trafficker to conceal his identity. Drug traffickers, therefore, primarily rely on cash to conduct business,[22] so that third parties will not have records of such transactions.[23] In addition, most drug traffickers fail to keep detailed financial information, because the IRS has discretion to use the drug trafficker's records to calculate his income.[24] Because drug traffickers keep few, if any, records, and must conceal their identity or risk prosecution, drug dealers rarely report their illegal income to the government.[25]

Although drug traffickers are not anxious to report their illegal income, the IRS is eager to tax it. If the taxpayer cannot or will not employ a method of accounting that accurately reflects such income, the IRS will calculate the income for him.[26] Recognized accounting methods include the cash receipts and disbursements method, various accrual methods, and combinations of the foregoing.[27] Neither the Code and its corresponding regulations, nor the legislative reports prescribe any techniques for determining the taxpayer's income.[28] Due to the dearth of legislative guidance, the IRS and the courts have shaped the doctrine of income reconstruction.[29]

---

21. *See, e.g.*, Jackson v. Commissioner, 73 T.C. 394, 400 (1979) (IRS calculations of taxable income acceptable because taxpayer had no records that accounted for an expensive car, large sums of cash, ability to rent several apartments for girlfriends, and the maintenance of an expensive gambling habit); *Curtis*, 59 T.C.M. at 552 (taxpayer filed no returns and failed to maintain or produce any records); Intersimone v. Commissioner, 53 T.C.M. (CCH) 1073, 1075 (1987) (agent calculated taxpayer's income by analyzing bank deposits and brokerage accounts statements, taxpayer offered no evidence to rebut the agent's determination); *Graff*, 52 T.C.M. at 1029 (IRS forced to resort to strong circumstantial evidence that taxpayer manufactured and sold methaqualone because taxpayer did not maintain accounting records); and Galluzzo v. Commissioner, 43 T.C.M. (CCH) 199, 203 (1981) (taxpayer kept no sales records of illegally diverted cocaine intended for pharmaceutical use).

22. *See* Molefsky, *supra* note 4, at 10.

23. These third parties are generally banks. Cash transactions can circumvent banks, unlike checking account transactions. Cash leaves no "paper trail" like a checking account, which produces cancelled checks, deposit slips, and a permanent bank record.

24. The IRS partially relied on a taxpayer's records to calculate his taxable income in Schmitz v. Commissioner, 55 T.C.M. (CCH) 658 (1988). Schmitz maintained that his diary was used to impress his drug supplier and did not include an allowance for returns. The taxpayer also asserted that he sold the drugs at a five to six percent mark-up. The court found the profit margin to be extremely low for such a risky business. Schmitz's testimony was, therefore, discredited. *Id.* at 661. *See also* Ryan v. Commissioner, 57 T.C.M. (CCH) 747, 751, *reconsid. denied*, 59 T.C.M. (CCH) 50 (1989) (taxpayer's certified public accountant's testimony that records were adequate discounted because taxpayer did not introduce such records into evidence).

25. Taxpayers who fail to report their taxable income are subject to civil and criminal tax penalties. *See infra* text accompanying notes 54-126.

26. I.R.C. § 446(a) (1986) allows the taxpayer to compute taxable income under the accounting method which he regularly employs. However, I.R.C. § 446(b) (1986) provides that if the taxpayer uses no accounting method, or his method of accounting does not clearly reflect income, the IRS has discretion to choose a method which does show the taxpayer's income.

27. Treas. Reg. § 1.446-1(a)(1) (as amended in 1987).

28. S. REP. NO. 1622, 83rd Cong., 2d Sess. 4349-50 (1954), *reprinted in* 2 1954 LEGISLATIVE HISTORIES AND CONGRESSIONAL DOCUMENTS 299 (B. Reams ed. 1982) [hereinafter S. REP. NO. 1622]. The legislative history merely restates I.R.C. § 446(b).

29. *See infra* notes 127-52 and accompanying text.

Procedural Tools

In addition to reporting-related requirements, the Code has procedural provisions to allow for a quick assessment of taxes.[30] Drug traffickers usually attempt to flee with their assets once they realize law enforcement officials may be aware of their drug operations. These assets are critical to the government's case. First, the assets may be evidence of an illicit drug trafficking ring.[31] Second, the IRS agent may use the assets to compute taxable income.[32] Finally, the assets may be the only way the taxpayer can satisfy his tax obligation.[33] Therefore, law enforcement officials, including the IRS, must be able to act quickly to apprehend the drug trafficker and ensure that his assets remain intact.

To succeed in drug cases, agents must be relatively free of bureaucratic red tape, while employing procedures that afford the taxpayer judicial review of the agent's determinations.[34] The agent must quickly compute the taxpayer's unreported income.[35] Then, armed with the tax computation, the agent may utilize either the jeopardy assessment or termination assessment, which provide for quick calculation of taxes.

A jeopardy assessment is an immediate determination of a taxpayer's liability, together with interest, additional amounts, and additions to the tax as provided for by law.[36] An IRS officer[37] must assess a tax deficiency when the officer believes any further delay in proceedings will endanger collection.[38]

Termination assessments serve to assess tax, along with applicable interest and penalties, on the current taxable year, the preceding taxable year, or both,

---

30. These procedural tools include jeopardy assessments (I.R.C. § 6861 (1986)) and termination assessments (I.R.C. § 6851 (1986)). *See infra* notes 36 & 39, and accompanying text for their respective definitions.

31. *See, e.g.*, Jones v. Commissioner, 903 F.2d 1301, 1302 (10th Cir. 1990) (search of taxpayer's residences netted assets worth millions of dollars, including over $1.5 million in cash, gold, jewelry, furs, two Mercedes Benz automobiles, guns, plane tickets, and drugs).

32. *See, e.g.*, *Graff*, 52 T.C.M. at 1027 (IRS agent and police officer collaborated in calculating taxpayer's drug trafficking income based on the number of drums of anthranilic acid seized).

33. *See, e.g.*, *Kingsley*, 58 T.C.M. at 1429 (government filed in rem forfeiture complaints with respect to the seizure of the taxpayer's house and its contents, safety deposit box, bank accounts, and girlfriend's automobile).

34. Congress enacted I.R.C. § 7429 in 1976 to afford taxpayers prompt judicial review for both jeopardy and termination assessments. For instance, § 7429 includes provisions requiring the IRS to give the taxpayer the basis for which it made the assessment and inform the taxpayer of the procedural requirements for review and redetermination. Pub. L. No. 94-455, 90 Stat. 1695 (1976) (codified as amended at I.R.C. § 7429 (1986)).

35. Agents are especially aware of the urgency of narcotics cases. Internal Revenue Manual (CCH) § 4584.2 (rev. 1982) [hereinafter I.R.M.].

36. Treas. Reg. § 301.6861-1(a) (as amended in 1986). *See infra* text accompanying notes 54-57 for an explanation of additions to tax.

37. Specifically, this person must be the district director or director of an IRS service center. Treas. Reg. § 301.6861-1(a) (as amended in 1986).

38. *Id.* "Endanger" encompasses one or more of the following conditions: (1) the appearance that the taxpayer intends to either depart from the country or conceal himself; (2) an indication that the taxpayer is planning to put his property beyond the reach of the government by concealing it, removing it, transferring it to other persons, or destroying it; or (3) the taxpayer's financial condition is endangered. Treas. Reg. § 1.6851-1(a)(1)(i)-(iii) (as amended in 1978).

as the situation warrants.[39] The current year's tax assessment is based on the taxpayer's liability from the first day of the year to the day of assessment.[40] The taxpayer's taxable year does not end upon assessment. However, the tax does become immediately due and payable.[41] The taxpayer's income tax return, therefore, reflects the entire year's income, deduction and credit items, not just the amount stated on the assessment.[42] In addition, the IRS credits the taxpayer with any tax collected due to the termination assessment.[43]

Termination and jeopardy assessments have many similar features, and a few distinctions. The IRS makes both assessments under the same exigent circumstances.[44] The tax computation includes applicable interest and penalties.[45] Moreover, payment and bond provisions are substantially the same.[46] The notice requirements, however, vary substantially. If the IRS sends the jeopardy assessment before the deficiency notice,[47] the IRS must mail a deficiency notice within sixty days after making the jeopardy assessment.[48] The IRS mails deficiency notices based upon termination assessments when the taxpayer's taxable year ends, not when it computes the termination assessment.[49] Thus, the taxpayer must wait substantially longer for the deficiency notice in a termination assessment than in a jeopardy assessment. A delay in receiving a deficiency notice can have a profound effect on the appeals process.[50] Finally, a termination assessment may not be used for any year in which the IRS chooses to employ a jeopardy assessment.[51]

---

39. I.R.C. § 6851(a)(1).

40. Treas. Reg. § 1.6851-1(a)(2) (as amended in 1978). A termination assessment can include a period shorter than one year. In contrast, a deficiency notice includes the taxpayer's entire taxable year.

41. Treas. Reg. § 1.6851-1(a) (as amended in 1978).

42. *Id.*

43. Treas. Reg. § 1.6851-1(a)(2) (as amended in 1978).

44. Both assessments rely on the conditions put forth in Treas. Reg. § 1.6851-1(a)(i)-(iii) (as amended in 1978). *See supra* note 38. In addition, the IRS can make either type of assessment if the taxpayer has more than $10,000 in cash, and does not claim ownership of the cash. I.R.C. § 6867 (1986). Even if the taxpayer asserts that the money belongs to someone else, the Service may make either assessment if the government cannot readily ascertain the identity of that individual. *Id.*

45. I.R.C. § 6851(a)(1) (1986).

46. Treas. Reg. § 1.6851-1(c) (as amended in 1978).

47. A deficiency is the difference between the amount of tax, if any, which the taxpayer paid by the due date of the return, and the correct liability for the taxable year. I.R.C. § 6211(a) (1986). A deficiency notice is what the IRS sends via certified or registered mail to officially notify the taxpayer of the deficiency. I.R.C. § 6212(a) (1986).

48. I.R.C. § 6861(b) (1986).

49. I.R.C. § 6851(b) (1986). The deficiency notice must be sent to the taxpayer within sixty days after the later of the date on which the taxpayer files his income tax return, or the due date of the return, taking into account all extensions. Treas. Reg. § 1.6851-1(b) (as amended in 1978).

50. For example, if the taxpayer were given a termination assessment close to the beginning of the tax year, he could wait well over a year to receive the deficiency notice. This substantially delays the taxpayer's redress in Tax Court, because the Tax Court's jurisdiction arises from the deficiency notice. TAX CT. R. 13(a), (c). I.R.C. § 7429 helps alleviate this hardship by allowing the taxpayer thirty days to request an IRS review of its findings. This section also provides that the taxpayer may seek judicial review if he is not satisfied with the IRS review. The taxpayer, therefore, must become familiar with § 7429 and its strict timetable for review and redetermination. Otherwise, any appeal may be significantly postponed.

51. I.R.C. § 6851(a)(4) (1986).

These two procedural tools are helpful in drug cases, and their use is pervasive.[52] These cases generally involve defendants who have large deficiency assessments and substantial assets (mostly cash), and who are primary figures in the drug operation under investigation.[53] Without these assessment procedures, drug traffickers' huge tax liabilities could go uncollected, therefore rendering the IRS's role in combatting drug trafficking wholly ineffective.

Penalties

In addition to procedural tools, the IRS utilizes penalties to punish drug traffickers for egregious or negligent behavior regarding their tax liability.[54] Taxpayers may be liable for civil and/or criminal penalties.[55] In fact, the taxpayer's acquittal of criminal tax evasion does not preclude the IRS from pursuing a civil case for the same taxable years.[56] Although both types of penalties may be pursued, the IRS is keenly aware of the need to balance the concurrent criminal and civil investigation.[57]

Civil Penalties

Civil penalties are generally a percentage of the taxpayer's liability.[58] No lawsuit is necessary to enforce civil penalties.[59] Most civil penalties assessed against drug trafficking taxpayers result from the taxpayer's failure to file a

---

52. *See, e.g., Jones*, 903 F.2d at 1303; Rogers v. United States, 511 F. Supp. 82, 83 (D. Minn. 1980); Petzoldt v. Commissioner, 92 T.C. 661, 671 (1989); *Jackson*, 73 T.C. at 399; *Curtis*, 59 T.C.M. at 550; *Kingsley*, 58 T.C.M. at 1429; *Graff*, 52 T.C.M. at 1028.

53. In *Curtis*, the taxpayer was arrested after 649 pounds of cocaine (wholesale value of $14,602,500) were discovered in the rear of his van. 59 T.C.M. at 549. He owned, among other things, five helicopters, property in California, and a Mercedes-Benz automobile. *Id.* at 549-50. The court upheld the IRS determination that Curtis had $7,301,250 in unreported income. *Id.* at 552.

54. *See, e.g.*, I.R.C. § 6662 (1986) (civil accuracy-related penalty dealing with taxpayer negligence); I.R.C. §§ 7201-7203 (1986) (criminal penalties dealing with willful failures to evade or pay taxes, or to file a return). Interest charges, however, are not considered penalties. Interest is designed to compensate the government for the time value of the tax between the date the tax was due and the date it was paid. Taxpayers pay interest on delinquent taxes owed to the government pursuant to I.R.C. § 6601 (1986).

55. Dillon v. Commissioner, 42 T.C.M. (CCH) 1364, 1369-70 (1981), *aff'd per curiam*, 83-1 U.S.T.C. (CCH) ¶ 9177 (1983). In *Dillon*, the court held that imposition of a civil tax penalty after a taxpayer has been convicted of its criminal counterpart does not violate the double jeopardy clause of the fifth amendment. *Id.* at 1370. The court reasoned that civil penalties are remedial rather than punitive in nature. *Id.* Furthermore, Congress intended to permit the imposition of civil penalties in addition to punishment in criminal proceedings. *Id.*

56. This includes a jury verdict or a directed verdict. Gonzalez v. Commissioner, 36 T.C.M. (CCH) 982, 988 (1977). The court granted Gonzalez' motion for directed verdict at a previous trial for criminal tax evasion. *Id.* The court in his subsequent civil action did not permit collateral estoppel because of the difference in the burden of proof. *Id.*

57. The Service's policy is to maximize civil enforcement of the tax laws without endangering criminal prosecution. *See generally* I.R.M., *supra* note 35, § 9324.31 (rev. 1984). Additionally, a guilty plea to a charge of criminal tax evasion estops a taxpayer from contesting a civil fraud charge. *See infra* note 101 and accompanying text.

58. *See infra* note 296 for a comprehensive example.

59. I.R.C. §§ 6665(a), 6671(a) (1986). The taxpayer, however, may seek redress in Tax Court if he feels the assessment is erroneous. *See* I.R.C. § 6213.

return,[60] understatement of income,[61] and fraudulent concealment of illicit income.[62]

A. Failure-to-file penalties

The Service computes failure-to-file penalties on the tax liability owed less tax payments previously made.[63] Internal Revenue Code section 6651 lists several types of failure-to-file penalties and their differing penalty rates.[64] In addition, this section carries a minimum penalty.[65]

Although failure-to-file penalties may overlap, I.R.C. section 6651 resolves that situation. When a taxpayer fails to file a timely return, he often fails to pay the tax due and is, therefore, subject to penalties for late payment and failure to file.[66] However, the penalties will offset each other in any month that both penalties apply, so that the net result will equal the failure-to-file penalty.[67] The minimum penalty for failure to file an income tax return is not offset by the failure-to-pay penalty.[68] Finally, if the taxpayer eventually files a return for a year under investigation, a fifteen percent penalty for fraudulently failing to file a tax return may be assessed along with a seventy-five percent accuracy-related fraud penalty.[69]

---

60. I.R.C. § 6651 (1986).

61. The accuracy-related penalty in § 6662 encompasses penalties for negligence (formerly § 6653), substantial understatement of income tax (formerly § 6661), substantial valuation overstatement under Chapter 1 (formerly § 6659), substantial overstatement of pension liabilities (formerly § 6659A), and substantial estate or gift tax valuation understatement (formerly section 6660).

62. I.R.C. § 6663 (1986) (formerly I.R.C. § 6653).

63. I.R.C. § 6651(a) (1986). An exception to this general rule is when the failure to file is due to reasonable cause. Reasonable cause is found if the taxpayer exercises ordinary business care and prudence, yet nevertheless is unable to file the return within the prescribed time period. Treas. Reg. § 301.6651-1(c)(1) (as amended in 1973).

64. The § 6651 penalties are as follows:

TYPE	RATE: PER MONTH	MAXIMUM
Failure to file (§ 6651(a)(1))	5%	25%
Fraudulent failure to file (§ 6651(f))	15%	75%
Failure to pay tax stated in return or deficiency notice (§ 6651(a)(2)–(3))	.5%	25%

65. The minimum penalty is the lesser of $100 or the amount of tax owed on the return. This only applies if the income tax return is not filed within sixty days of its due date, including extensions. I.R.C. § 6651(a)(3).

66. A taxpayer who has not filed a tax return will nevertheless be liable under § 6651(a). The "failure to pay tax shown on a return" penalty is assessed on tax that *should* have been shown on the return. Treas. Reg. § 301.6651-1(a)(3) (as amended in 1982).

67. The late filing penalty is reduced by the failure-to-pay penalty. The net late filing penalty is added to the failure-to-file penalty. The maximum penalty in any month, therefore, is five percent of the tax liability, or fifteen percent in the case of fraud. I.R.C. § 6651(c)(1).

68. *Id.*

69. I.R.C. §§ 6663, 6664(b) (1986). The fraud penalty is discussed *infra* in text accompanying notes 79-107.

B. Understatement of income and the accuracy-related penalty

The newly consolidated accuracy-related provisions apply to income tax returns due on or after January 1, 1990.[70] Returns before that date are subject to several separate penalty provisions.[71] To assess an accuracy-related penalty in drug cases, the IRS must show that the taxpayer acted negligently[72] or that a substantial understatement of income tax exists.[73] The tax on the underpayment attributable to either negligence or a substantial understatement of income tax is subject to a twenty percent penalty.[74] Finally, the IRS can assess a negligence penalty based on the accuracy-related penalty and the fraud penalty[75] against a single underpayment.[76] The underpayment must, however, be divided into separate parts attributable to each penalty; no overlap is allowed.[77]

Drug trafficking cases have not, for the most part, generated much substantive discussion about failure-to-file and accuracy-related penalties.[78] This is probably because failure to pay income tax and failure to file an income tax return are questions of fact.

C. Fraud Penalty

On the other hand, courts have widely discussed fraud.[79] The seventy-five percent penalty on underpayment of income tax[80] creates an economic incentive to challenge the assessment. In addition, the illegal nature of the drug business makes such cases ideally suited for the IRS to assess a penalty based upon the taxpayer's intent to conceal or hide income.[81]

A prima facie tax fraud case consists of two elements. First, the taxpayer underpaid his income tax.[82] Second, the taxpayer intended to evade taxes.[83] The IRS has the burden of proving by clear and convincing evidence that the

---

70. H.R. REP. NO. 247, 101st Cong., 1st Sess. 4, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS 2864.

71. *See supra* note 61 and accompanying text.

72. Negligence includes any failure to make a reasonable effort to comply with the provisions of the Code, and encompasses a careless, reckless, or intentional disregard of the rules. I.R.C. § 6662(c) (1986).

73. There is a substantial understatement of income tax if the understatement exceeds the greater of ten percent of the tax required to be shown on the return or $5,000. I.R.C. § 6662(d)(1).

74. I.R.C. § 6662(a).

75. I.R.C. § 6663.

76. I.R.C. § 6662(b).

77. *Id.*

78. This is true before and after the consolidation of the accuracy-related penalties pursuant to the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721, 103 Stat. 2395-97 (1989) (codified as amended at 26 U.S.C. §§ 6621(c), 6653, 6659A, 6660-6665 (Supp. I 1989).

79. Fraud is defined as an "intentional wrongdoing designed to evade tax believed to be owing." *Petzoldt*, 92 T.C. at 698.

80. *See* I.R.C. § 6663(a).

81. The government can prove intent in many ways. *See infra* notes 86-107 and accompanying text.

82. *Curtis*, 59 T.C.M. at 552.

83. The IRS can prove intent if the taxpayer purposefully concealed, misled, or otherwise prevented collection of the tax liability. *Petzoldt*, 92 T.C. at 699.

underpayment existed for the years under examination.[84] The Service must further prove that some or all of the underpayment was due to fraud.[85]

The trier of fact determines the existence of fraud.[86] The trier of fact must consider independent evidence of fraudulent intent, because fraud is never presumed or imputed.[87] If a taxpayer's ability to form the requisite intent is questionable, the court must closely scrutinize the direct evidence.[88]

In *Wilson v. Commissioner*, the Tax Court considered whether the taxpayer had the ability to form fraudulent intent.[89] The taxpayer suffered from viral encephalopathy, which caused him to become mentally confused, disoriented, and emotionally immature.[90] The debilitating disease did not automatically preclude the taxpayer from forming the requisite intent. Rather, the court found three factors indicating Wilson intended to evade taxes.[91] First, the taxpayer was competent to stand trial for criminal charges of possession with the intent to sell illegal narcotics.[92] Second, the jury found him guilty of these charges, despite his defense of mental incapacity.[93] Finally, the court found that Wilson did not suffer from a significant mental impairment at the filing date of his income tax return.[94] The court, therefore, held that Wilson committed tax fraud because he was able to form the requisite intent to evade income taxes, and did in fact evade such taxes.[95]

Unlike the *Wilson* case, fraud is generally proven by circumstantial evidence and reasonable inferences because direct proof of the taxpayer's intent is rarely available.[96] The court in *Bradford v. Commissioner*[97] enumerated several indices of fraudulent intent. They include understating income, maintaining inadequate records, and failing to file tax returns or making estimated payments.[98] Additional factors consist of concealing assets, dealing in cash, failing to cooperate with the IRS, and implausible or inconsistent explanations of behavior.[99] Courts also scrutinize illegal activities, and the taxpayer's attempt to conceal such enterprises.[100] Finally, a taxpayer will be collaterally

---

84. *Id.*
85. *Id.*; I.R.C. § 7454(a) (1986).
86. *Petzoldt*, 92 T.C. at 699.
87. *Id.*
88. Wilson v. Commissioner, 76 T.C. 623, 634 (1981).
89. 76 T.C. 623 (1981).
90. *Id.* at 629.
91. *Id.* at 636-37.
92. The court made the competency determination when Wilson was suffering from the encephalitic condition. *Id.* at 636.
93. Wilson was not collaterally estopped from claiming that he did not have the mental capacity to form the requisite intent in the civil case. The criminal verdict, however, was used as evidence of intent. *Id.*
94. *Id.* at 637.
95. *Id.*
96. *Petzoldt*, 92 T.C. at 699.
97. 796 F.2d 303 (9th Cir. 1986).
98. *Id.* at 307.
99. *Id.*
100. *Id.* at 308. Similarly, the *Curtis* court held that the taxpayer's illegal drug trafficking activities were prima facie proof of his willingness to conceal income from the government with the intent to evade taxes. 59 T.C.M. at 570.

estopped from asserting any defense to a civil fraud charge if he is criminally convicted of willfully attempting to evade taxes.[101]

There is no one factor or set of factors which is dispositive; different factors persuade different courts. Most courts feel comfortable pointing to several compelling indices of fraud.[102] Fraud will not be found, however, when the government cannot produce sufficient evidence linking the taxpayer to any income-producing activity, either legal or illegal.[103]

Reporting illegal income may work to the taxpayer's advantage in a fraud determination. In *Johnson v. Commissioner*, the taxpayer reported most of his drug earnings as income from an unidentified trade or business.[104] The court disallowed most of the taxpayer's business expenses, such as trips to New York to purchase heroin, bail for business associates, and attorney's fees, because the taxpayer did not have receipts for such transactions.[105] Most of his tax deficiency arose from the court's disallowance of these expenses, not from unreported income.[106] Consequently, the court found that no fraud existed because the understatements were not due to intentional omissions.[107]

Criminal Penalties

Criminal actions, as opposed to civil assessments, require more thought; the agent must appraise numerous factors before he starts his criminal investigation.[108] Such factors include the available government resources,[109] the breadth of the potential investigation,[110] and indices of fraud discovered during the course of the investigation.[111] The agent in *Gonzalez v. Commissioner* concluded that the taxpayer was not involved in smuggling narcotics, despite an FBI report to the contrary.[112] The agent, however, determined that Gonzalez substantially understated his income.[113] He did not believe Gonzalez' story about the pre-existing wealth the taxpayer brought with him when he escaped from Cuba, because Gonzalez offered no documentation to support his contentions.[114] In addition, Gonzalez exercised his fifth amendment right to remain silent and declined to answer many of the agent's questions that could

---

101. *Kingsley*, 58 T.C.M. at 1440. The taxpayer will be collaterally estopped regardless of whether he pled guilty or was found guilty in a trial on the merits. *Id.*

102. *See, e.g., Petzoldt*, 92 T.C. at 701 (taxpayer failed to file tax returns for two years, drug income approximated $3.7 million); *Intersimone*, 53 T.C.M. at 1076-77 (taxpayer could not explain bank deposits and cash expenditures ranging from $7,000 to $94,500, admission that illegal source generated income).

103. *Graff*, 52 T.C.M. at 1032 (court found sufficient evidence linking taxpayer to income-producing activity, which included registering assets in another's name, substantial cash purchases, and guilty plea to criminal drug charges).

104. 41 T.C.M. (CCH) 769, 772 (1981).

105. *Id.* at 775. The Congress requires substantiation for many expenses. *See infra* note 152. *But see infra* note 151 and accompanying text.

106. 41 T.C.M. at 775.

107. In addition, these understatements were deemed not to be material. *Id.*

108. I.R.M., *supra* note 35, § 9321.1 (rev. 1990).

109. *Id.*

110. *Id.*

111. *Id.* § 9322.1 (rev. 1981). This includes the taxpayer's willful failure to file a required return or his lack of cooperation during the investigation phase. *Id.*

112. *Gonzalez*, 36 T.C.M. at 987.

113. *Id.*

114. *Id.*

have exonerated him.[115] Consequently, the agent recommended criminal tax evasion prosecution.[116]

Criminal penalties involving drug traffickers generally fall into three categories: 1) tax evasion,[117] 2) failure to file a return,[118] and 3) fraud.[119] Willfulness must be proven for each penalty.[120] These criminal penalties may include terms of imprisonment[121] and/or fines.[122]

The need for courts to impose criminal tax penalties upon drug traffickers seems dubious.[123] Drug dealers already face stiff prison sentences for trafficking narcotics. In contrast, sentences from criminal tax penalties are frivolous.[124] Furthermore, many criminal fines seem comparatively small if civil tax proceedings result in huge additions to tax where the drug trafficker has a large tax liability.[125] The United States Supreme Court reminds courts that the IRS's main responsibility is to collect revenue.[126] This is good advice when courts (and the IRS) consider tax penalties.

INCOME RECONSTRUCTION — PROCEDURE AND METHODS

Taxable income is the foundation for the calculation of assessments and penalties.[127] The IRS uses the specific item method[128] and the indirect method[129] to determine and prove taxable income. The Service uses income reconstruction techniques in civil and criminal tax cases, as well as asset

---

115. *Id.*
116. *Id.*
117. I.R.C. § 7201 (1986).
118. I.R.C. § 7203 (1986).
119. I.R.C. §§ 7206, 7207 (1986).
120. "Willful" is defined as a voluntary, intentional violation of a known legal duty. United States v. Pomponio, 429 U.S. 10, 11, *reh'g denied*, 429 U.S. 987 (1976). Willful does not mean negligent or grossly negligent. United States v. Dahlstrom, 713 F.2d 1423, 1427-28 (9th Cir.), *cert. denied*, 466 U.S. 980 (1983).
121. *See* I.R.C. § 7201 (five years); I.R.C. § 7203 (one year); I.R.C. § 7206 (three years); I.R.C. § 7207 (one year). These represent maximum prison sentences.
122. *See* I.R.C. § 7201 ($100,000); I.R.C. § 7203 ($25,000); I.R.C. § 7206 ($100,000); I.R.C. § 7207 ($10,000). These represent maximum fines that are applicable only to individuals.
123. *See* H. BALTER, TAX FRAUD AND EVASION ¶ 11.01[1] (5th ed. 1983). The author questions the need for criminal penalties in light of civil additions to tax.
124. *See supra* note 121.
125. *See infra* note 296 and accompanying text for a comprehensive example.
126. "The primary goal of the income tax system ... is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc." Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979) (taxpayer's write-down of inventory disallowed).
127. All additions to tax are based on the determination of taxable income. For a comprehensive example of additions to tax, see *infra* note 296 and accompanying text.
128. The specific item method involves verification or determination of each income or expense item affecting the taxpayer's liability. I.R.M. *supra* note 35, § 4231, at ch. 810 (rev. 1981).
129. The indirect method requires the development of circumstantial proof of income by utilizing a variety of income reconstruction methods. These include net worth, cash expenditures (source and application of funds), bank deposits, various miscellaneous methods, or combinations of the foregoing. *Id.*

forfeiture proceedings.[130] IRS agents employ these techniques in investigations of a variety of illegal businesses.[131] Income reconstruction is also featured in many high profile tax cases.[132]

The IRS also uses income reconstruction methods to test the accuracy of taxpayer's books, even though the records may appear reliable.[133] In *Holland v. United States*, the Court stated:

> [T]he defendant's books were more consistent than truthful, and ... many items of income had disappeared before they had even reached the recording stage. Certainly Congress never intended to make § 41[134] a set of blinders which prevents the Government from looking beyond the self-serving declarations in a taxpayer's books.[135]

More often than not, however, a taxpayer's failure to keep adequate books and records requires the IRS to use indirect income reconstruction methods. The IRS generally has a substantial amount of freedom to utilize income reconstruction methods where illegal enterprises, such as drug trafficking, are involved, especially when the taxpayer keeps no records or files no tax returns.[136] The reasoning is obvious — taxpayers should not be allowed to escape paying taxes just because they maintain incomplete records.[137] In addition, taxpayers should not deprive the IRS of a rational foundation from which to assess income tax.[138] Finally, IRS computations need not be exact. In *United States v. Johnson*,[139] the Supreme Court reasoned that "[t]o require ... more meticulous proof (of) unreported profits from an elaborately concealed

---

130. *See, e.g.*, United States v. Lewis, 759 F.2d 1316 (8th Cir.), *cert. denied*, 474 U.S. 994 (1985) (income reconstruction approved for computing assets accumulated from illegal drug sales). Forfeiture of such assets is provided for under 21 U.S.C. § 848 (1988).

131. *See, e.g.*, United States v. Johnson, 319 U.S. 503, *reh'g denied*, 320 U.S. 808 (1943) (gambling); Roman V., Inc. v. Commissioner, 52 T.C.M. (CCH) 1278 (1987) (prostitution); Lazcano v. Commissioner, 55 T.C.M. (CCH) 247 (1988) (money laundering). These techniques, however, can be used to reconstruct income of legitimate businesses as well. *See, e.g.*, Burke v. Commissioner, 56 T.C.M. (CCH) 742 (1988) (waitstaff tips); Delaney v. Commissioner, 20 T.C.M. (CCH) 1602 (1961) (lawyer); Blanchard v. Commissioner, 12 T.C.M. (CCH) 550 (1953) (doctor).

132. The gangster Al Capone was perhaps the most (in)famous taxpayer against whom income reconstruction techniques were employed. He was not convicted for the notorious crimes he allegedly committed. Rather, he was convicted of income tax evasion, which was based on the net worth method of income reconstruction. Capone v. United States, 51 F.2d 609 (7th Cir.), *cert. denied*, 284 U.S. 669 (1931).

133. *See* Holland v. United States, 348 U.S. 121, 131, *reh'g denied*, 348 U.S. 932 (1954). The *Holland* Court only discussed the net worth method of income reconstruction, which is discussed *infra* at text accompanying note 213. However, *Holland* is a hallmark decision for indirect methods of income reconstruction, and its reasoning is generally thought to be transcendent.

134. Section 41 was the precursor to § 446, which is the statutory foundation for income reconstruction methods. *See* S. REP. NO. 1622, *supra* note 28.

135. *Holland*, 348 U.S. at 132.

136. *See, e.g.*, *Jackson*, 73 T.C. at 403; *Petzoldt*, 92 T.C. at 693.

137. *Bradford*, 796 F.2d at 306 (citing Adamson v. Commissioner, 745 F.2d 541, 548 (9th Cir. 1984)).

138. *Id.*

139. 319 U.S. 503 (1943).

illegal business, would be tantamount to holding that skilful concealment is an invincible barrier to proof."[140]

The taxpayer in *Petzoldt v. Commissioner* became acutely aware of the breadth of the government's income reconstruction powers.[141] He vigorously opposed the deficiency assessment of more than $1.8 million, which did not include penalties or interest.[142] His complaints, however, fell upon an unsympathetic court. Petzoldt gave no evidence to prove the correct taxable income.[143] He did not file a tax return for the years under investigation.[144] Furthermore, the low taxable income reported on his tax returns for the years not under investigation was inconsistent with his sudden increase in wealth.[145] The court, therefore, allowed the IRS income determination to stand in its entirety.[146]

Notwithstanding these broad powers, the IRS must work within some limits. The government must employ reasonable means to reconstruct income.[147] In addition, the agent must be relatively accurate when determining the taxpayer's income. Although absolute certainty is both improbable and impractical, the agent must be as precise as possible.[148] When an agent discovers that an underlying assumption in his calculations is incorrect, he must adjust the computation to reflect the newly-discovered facts.[149] If a taxpayer impedes the IRS from making an accurate determination, courts generally give the IRS more latitude in computing income.[150]

Similarly, courts often allow the taxpayer latitude in his computations. In *Cohan v. Commissioner*, the court allowed the taxpayer some deduction, even though he had no proof.[151] Congress, however, has significantly limited the allowance of many business deductions by requiring taxpayers to

---

140. *Id.* at 517-18.
141. 92 T.C. at 693.
142. *Id.* at 662.
143. *Id.* at 696.
144. *Id.*
145. *Id.*
146. *Id.* at 698.
147. *Id.* at 693.
148. Cohan v. Commissioner, 39 F.2d 540, 543-44 (2d Cir. 1930) (taxpayer allowed some business expenses, despite scanty records).
149. *Graff*, 52 T.C.M. at 1031. In computing gross sales, the police detective based his gross income estimates on the number and size of chemical drums seized at the time of Graff's arrest. *Id.* at 1027. This estimate was not supported by the police report. The court, therefore, made the correction in gross sales. *Id.* at 1031. The court claimed to have reduced the police detective's computation. However, the taxpayer actually lost ground by comparing the initial computation (*Id.* at 1027) and the adjusted figure (*Id.* at 1031). The court made the same computation, but did not give the taxpayer the benefit of the personal exemption for both years. The mistake appears to be inadvertent because the omission was not discussed in the opinion.
150. "Absolute certainty in [reconstructing income] is usually impossible and is not necessary; the Board [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making." *Cohan*, 39 F.2d at 543-44.
151. *Id.* at 544. The taxpayer, the famous playwright George Cohan, was unable to account for all his business expenses, most of which involved entertaining actors, employees, and drama critics. The IRS denied all expenses because Cohan could not show substantiation. Although the court did not allow the taxpayer his full expense estimate, it did allow a small deduction because there was some basis for the expense.

substantiate expenses.[152] Courts, therefore, are not likely to be lenient with taxpayers who keep inadequate books and records, file no tax returns, are unhelpful in the investigation, and engage in illegal activity.

Burden of Proof

In income reconstruction cases, the IRS has the initial burden of producing substantive evidence that demonstrates the taxpayer received unreported income.[153] Some courts initially believed that the government must show the taxpayer's books to be inadequate *before* the IRS used an indirect income reconstruction method.[154] The United States Supreme Court, in the *Holland* case, expressly overruled this reasoning.[155] The taxpayer in *Holland* kept meticulous books, however most of his income did not pass through his accounting records.[156] Consequently, his accounting method and records were adequate only for the income which was reported. The Court, therefore, found it necessary to employ an indirect method of income reconstruction to test the *validity* of the taxpayer's books.[157] Once the IRS finds the taxpayer's records do not clearly reflect income, I.R.C. section 446(b) allows agents to utilize methods which do reflect income. The IRS then has the burden of choosing a method of income reconstruction which reasonably reflects the taxpayer's income.[158]

Although the IRS has the initial burden of proof, the government's deficiency notice is presumed correct.[159] The taxpayer has the burden of proving the deficiency notice incorrect.[160] The court will not look behind the notice to examine the IRS's evidence, motives, administrative policies, or technical procedures reflected in the notice.[161] Both parties, therefore, start with a clean

---

152. Congress requires substantiation for travel (including meals and lodging while away from home), entertainment, and listed property (including automobiles, computer equipment, cellular phones, and property used for amusement or entertainment). I.R.C. § 274(d) (1986).

153. *See* Welch v. Helvering, 290 U.S. 111, 115 (1933).

154. *See* United States v. Riganto, 121 F. Supp. 158, 161-62 (E.D. Va. 1954) (no tax fraud because government failed to show inadequacy of taxpayer's books and reasonableness of income reconstruction method). The court rested its holding on what is now I.R.C. § 446(a), which requires taxable income to be computed under the method of accounting the taxpayer uses to regularly keep his books. Section 446(b) authorizes the Service to change accounting methods when the taxpayer's method does not *clearly* reflect income. I.R.C. § 446(b) (1986) (emphasis added).

155. Indirect methods of income reconstruction are not methods of accounting, and therefore do not depend on the adequacy of the taxpayer's books for validity. *Holland*, 348 U.S. at 131.

156. "[T]he defendants' books were more consistent than truthful, and ... many items of income had disappeared before they had even reached the recording stage." *Id.* at 132.

157. *Id.* at 131-32.

158. *Riganto*, 121 F. Supp. at 161 ("The Government must also show that the ... method ... adopted ... reasonably reflect[s] the income of the taxpayer."). *But see* Bradstreet Co. v. Commissioner, 65 F.2d 943, 945 (1st Cir.), *cert. denied*, 290 U.S. 692 (1933) (the burden is equally on the IRS and the taxpayer).

159. *See* Llorente v. Commissioner, 649 F.2d 152, 156 (2nd Cir. 1981) (IRS determination that taxpayer earned income from illicit drug sales unfounded because no evidence taxpayer bought or sold cocaine), *aff'd in part, rev'd in part*, 649 F.2d 152 (2d Cir. 1981).

160. *See Welch*, 290 U.S. at 115; *Petzoldt*, 92 T.C. at 687.

161. *Petzoldt*, 92 T.C. at 687-88. The rationale behind this policy is that a trial before the Tax Court is a trial de novo, and therefore the merits of the case, not the record from a prior

slate in Tax Court, and the taxpayer must take the first step in proving his innocence.

In order for the taxpayer to successfully rebut the deficiency notice's presumption of correctness, he must show that the notice is arbitrary, capricious, and excessive.[162] The deficiency notice's presumption of correctness is only as strong as its rational foundation.[163] The taxpayer must offer some evidence to show that the notice is arbitrary, even though a deficiency notice may appear wholly erroneous on its face.[164]

Substantive testimony is important for both parties to prove or disprove a rational foundation. Witness credibility is a critical factor in rebutting the presumption of correctness attached to the deficiency notice.[165] Credibility of government witnesses is also important, especially when the government can offer no other proof to corroborate the testimony.[166] Credible testimony, however, may not be enough for the taxpayer to rebut the deficiency notice. The taxpayer's financial records may bolster his case.[167] Credible substantive evidence, therefore, is vital for courts to determine whether the deficiency notice has a rational foundation.

There is, however, one exception to the general rule that the court will not look behind the deficiency notice. Courts require the IRS to link the tax-

---

administrative proceeding, must support the court's determination of the taxpayer's liability. *Jackson*, 73 T.C. at 400.

162. *Gary*, 35 T.C.M. at 822.

163. *Llorente*, 649 F.2d at 156. Otherwise, the IRS could put a taxpayer in an unfair or impossible situation by forcing him to prove a negative, i.e. that he did not receive the illegal income assessed against him. *Id.*

164. *See, e.g., Jones*, 903 F.2d at 1304. As a result of the taxpayer's arrest for selling illegal drugs, the government seized assets worth millions of dollars, including $1.5 million in cash. *Id.* at 1302. Shortly thereafter, the IRS sent Jones a deficiency notice for tax on $33 million in unreported income. *Id.* at 1303. The court stated:

> The $33 million income which the government assigned to Jones over a ten-month period is indeed a figure which almost defies credibility. This court has never directly addressed the outer boundary of reasonableness at which point the bare presumption afforded the Commissioner's assessment must ultimately give way; nevertheless, we believe that such a point probably does exist.

Id. at 1304. Nevertheless, the taxpayer did not sufficiently demonstrate that the government's figure was incorrect or arbitrary, nor did he prove that the government lacked a rational foundation for its assessment. The court, therefore, upheld the deficiency notice. *Id.* at 1305-06.

165. In *Estate of Gary v. Commissioner*, the IRS agent imputed income to the taxpayer-decedent based upon his personal drug expenditures. 35 T.C.M. at 821. The taxpayer's mother's testimony was the sole evidence at trial. She stated that the decedent was too sick to sustain a $200 a day heroin habit. Although the decedent died from acute narcotism, the testimony strongly persuaded the court to hold that the deficiency notice was groundless. The court, therefore, imputed no income to him. *Id.* at 822.

166. *See Jackson*, 73 T.C. at 402. The government relied on statements from an informant regarding the taxpayer's involvement in a drug ring. The informant, under arrest for a narcotics violation at the time of his statement, was probably trying to ingratiate himself with law enforcement officials, but he later jumped bail. *Id.* at 397. The court found for the taxpayer because the informant's testimony was "highly suspect" and the government failed to present any other evidence showing the taxpayer was involved in heroin sales. *Id.* at 402.

167. In *Galluzzo*, the taxpayer did not offer his own records to rebut the government's case. 43 T.C.M. at 211. Rather, he attempted to discredit the government's expert by "picking" at the testimony. The court gave little credence to Galluzzo's self-serving testimony. The court suggested that the taxpayer should have presented his own evidence as to what his net income

payer to a tax-generating event when it determines the taxpayer did not report illegal income.[168] In *Weimerskirch v. Commissioner*, the IRS claimed that the taxpayer failed to report income he received from selling heroin.[169] Weimerskirch offered his tax return to prove his income.[170] In addition, several witnesses testified on Weimerskirch's behalf, including his mother, who stated that she assisted with his support.[171] The IRS introduced no evidence to link Weimerskirch to drug trafficking, or to substantiate its computation of his taxable income.[172] The Tax Court held, however, that Weimerskirch failed to rebut the deficiency notice's presumption of correctness.[173] The Ninth Circuit disagreed, holding that the deficiency notice was arbitrary and erroneous because it was not supported by a sufficient evidentiary foundation.[174]

The *Weimerskirch* court combined and expanded the United States Supreme Court discussions of deficiency notices in *Helvering v. Taylor*[175] and *United States v. Janis*.[176] In *Taylor*, the Court declared that if the deficiency notice is excessive and without rational foundation, it will not be enforced unless the IRS can produce additional evidence to support its claim.[177] In *Janis*, the Court commented that resting a deficiency notice solely upon illegally seized evidence is a "'naked' assessment without *any* foundation whatsoever."[178] The Court went on to say that such a notice is arbitrary and erroneous, and is not subject to the usual presumption of correctness.[179] Thus, by linking the

---

was. *Id. But c.f. Schmitz*, 55 T.C.M. at 661 (taxpayer's drug records were used *against* him in determining taxable income).

168. Weimerskirch v. Commissioner, 596 F.2d 358, 362 (9th Cir. 1979), *reversing* 67 T.C. 672 (1977). This exception arose in the drug trafficking context, but is applicable to other types of illegal income. *See* Zuhone v. Commissioner, 883 F.2d 1317 (7th Cir. 1989) (investor in oil and gas wells); Paccar, Inc. v. Commissioner, 849 F.2d 393 (9th Cir. 1988) (truck manufacturer); Wells v. Commissioner, 47 T.C.M. (CCH) 796 (1983) (illegal lottery/numbers operation).

169. 596 F.2d at 359.

170. *Id.*

171. *Id.*

172. *Id.*

173. 67 T.C. 672, 675, *rev'd*, 596 F.2d 358.

174. *Weimerskirch*, 596 F.2d at 362. The court did not specify or imply what quantum of evidence the government would have needed in order to prevail. *Id.*

175. 293 U.S. 507 (1935) (IRS apportionment of purchase price found to be arbitrary).

176. 428 U.S. 433 (1976) (evidence obtained in violation of fourth amendment not excluded from federal civil tax proceeding, in absence of any proof of federal participation in illegality).

177. 293 U.S. at 515. The taxpayer in *Taylor* successfully challenged the IRS's valuations which caused the tax deficiency. *Id.* at 511. Courts have had difficulty in applying *Taylor*'s amorphous standard. *See Llorente*, 74 T.C. at 272 (Tannenwald, J., concurring). Judge Tannenwald suggests a case-by-case approach.

178. 428 U.S. at 441 (emphasis in original). The police illegally seized the taxpayer's wagering records and cash; therefore, the state could not criminally convict him. *Id.* at 438. In a separate tax proceeding, both the district and appellate court held that the taxpayer was not liable for taxes the IRS computed on illegally seized evidence. *Id.* at 439. The Supreme Court reversed, holding that the exclusionary rule does not extend to civil federal proceedings when state law enforcement officials illegally seize evidence. *Id.* at 460. The Court reasoned that the deterrent effect on law enforcement officials would not be served if such searches were subject to the exclusionary rule. *Id.* at 459-60. The reference to deficiency notices, therefore, was merely dicta.

179. *Id.* at 442.

substantive showing requirement of *Taylor* to the taxpayer's illegal income aspect of *Janis*, *Weimerskirch* requires the IRS to put forth evidence of the illegal activity in its prima facie case.[180] Consequently, the IRS must support its assertion that the taxpayer has unreported income from an illegal activity with a substantive showing *before* the deficiency notice's presumption of correctness attaches.[181]

One question *Weimerskirch* did not address is what quantum of proof is needed to link a taxpayer to an illegal activity. The Second Circuit answered that question in *Llorente v. Commissioner*.[182] Llorente, a Colombian, owned a New York City bar frequented by drug dealers.[183] He pleaded guilty to attempted conspiracy to criminally possess a controlled substance.[184] The government's main witness in Llorente's tax evasion trial was an undercover police officer.[185] The officer testified that he purchased cocaine at Llorente's bar, although never directly from Llorente.[186] The agent further stated that he overheard the taxpayer discuss the status of a cocaine shipment with another customer.[187] The agent testified that another informant claimed to have personally inspected six kilos of cocaine with Llorente.[188]

The Court of Appeals held that, in spite of this evidence and Llorente's criminal conviction on the drug-related conspiracy count, the government did not sufficiently link the taxpayer to tax-generating activities.[189] These incidents did "no more than place him on the fringes of illegal activity.... They hardly demonstrate that Llorente ever actually purchased or sold cocaine."[190]

The IRS's substantive showing that the taxpayer engaged in an illegal income-producing activity must have more than a "peripheral contact" with the illegal conduct.[191] The *Llorente* court set forth two requirements for the government to exceed the "peripheral contact" standard. First, the IRS must link the taxpayer with the illegal business.[192] Second, the taxpayer's connection to the illegal business must support an inference that the taxpayer was directly involved in the illegal tax-generating activity.[193] Courts, however, apply this standard unevenly.[194]

---

180. *Weimerskirch*, 596 F.2d. at 362.
181. Several circuits have adopted *Weimerskirch*. *See, e.g.*, *Zuhone*, 883 F.2d at 1325; Anastasato v. Commissioner, 794 F.2d 884 at 887 (3rd Cir. 1986); Gatlin v. Commissioner, 754 F.2d 921 at 923 (11th Cir. 1985); and *Llorente*, 649 F.2d at 156.
182. 649 F.2d. at 156.
183. *Id.* at 153-54.
184. *Id.* at 154.
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.* at 154-55.
189. *Id.* at 156. The purchase and sale of narcotics would have provided the direct link. *Id.*
190. *Id.* at 157.
191. *Id.* at 156.
192. *Id.*
193. *Id.*
194. In *Llorente*, a drug-related criminal charge and testimony from an undercover police officer were not enough evidence to directly link Llorente to an income-producing activity. *Id.* at 157. The *Petzoldt* court, however, was stricter with the taxpayer. The court relied on testimony from a witness under a grant of immunity. His testimony connected Petzoldt with drug

The *Weimerskirch* exception to the deficiency notice's presumption of correctness has its detractors. In *Jackson v. Commissioner*,[195] the court found the *Weimerskirch* rule broad and impractical.[196]

The breadth of the *Weimerskirch* holding, combined with the court's heavy reliance upon dictum in *Janis*, provides fodder for *Weimerskirch*'s critics. The *Weimerskirch* court, however, anticipated dissension. Taxpayers charged with receiving income from illicit sources, the court reasoned, should not be put in the impossible situation of having to prove a negative.[197] To put that heavy a burden on the taxpayer offended the court's sense of justice, due to the severe financial and psychological ramifications that might result to the taxpayer.[198]

Aside from the *Weimerskirch* exception, which puts a heavier burden on the government when it charges the taxpayer with receipt of illicit income, the onus is on the taxpayer. If he can show the deficiency notice was arbitrary or erroneous, the notice's presumption of correctness disappears, and the burden of proof shifts to the IRS.[199] The burden of proof also shifts to the IRS if the taxpayer meets his or her burden of disproving the deficiency notice's presumption of correctness by successfully showing the inaccuracy of IRS calculations.[200] The taxpayer will generally prevail by showing he was not the source of the money[201] and did not use the money in any way.[202] In addition, courts look at other factors, such as the credibility of the taxpayer and other

---

ledgers which merely had Petzoldt's alleged nickname written next to a marijuana purchase. The taxpayer also had narcotics and drug paraphernalia with him at the time of his arrest. *Petzoldt*, 92 T.C. at 690-91.

195. 73 T.C. 394.

196. *Id.* at 404. The court held that the IRS determination was arbitrary because of the insufficiency of evidence (an unreliable informant). Although the court did not rest its decision on *Weimerskirch*, it found that the *Weimerskirch* rule difficult to apply when analyzing the burden of proof. *Id.* The dissent found *Weimerskirch* especially troublesome, even though the Tax Court has a duty to follow the Ninth Circuit. "While I recognize that my views may differ from those expressed by the Ninth Circuit in reversing our decision in the *Weimerskirch* case, I am not prepared to follow the reversal of the Tax Court in that case." *Id.* at 405-06 (Quealy, J., dissenting).

197. *Weimerskirch*, 596 F.2d at 361.

198.

> Even the most innocent of persons would have difficulty in disproving such a serious charge as selling heroin, when the party making the charge was not required to present *any* evidence.... By its allegation that a taxpayer has unreported income from the sale of narcotics, the government is affixing a label, a label which in this case reads "heroin pusher." To allow the government to do this without offering any probative evidence linking the taxpayer to the activity runs afoul of every notion of fairness in our system of law.

Id. at 361-62 (emphasis in original).

199. *Jackson*, 73 T.C. at 402 (citing Pizzarello v. United States, 408 F.2d 579, 583 (2d Cir.), *cert. denied*, 396 U.S. 986 (1969)).

200. *Johnson*, 41 T.C.M. at 773.

201. *See, e.g.*, Kent v. Commissioner, 51 T.C.M. (CCH) 1605, 1607 (1986) (IRS taxed the wrong person because taxpayer merely drove the boat in drug smuggling operation and was not the principal who provided the necessary drugs and cash).

202. *See, e.g., Johnson*, 41 T.C.M. at 773 (court found no appreciable assets because revenue agent failed to locate assets and taxpayer proceeded *pro se*).

witnesses,[203] and the taxpayer's overall lifestyle.[204] Inaccuracy, however, does not mean that a deficiency notice is facially invalid because the amount of income claimed is incredibly high; the taxpayer must still offer enough evidence to refute the deficiency notice.[205] Except in limited circumstances, the taxpayer, therefore, must offer sufficient evidence in order to rebut the deficiency notice's presumption of correctness.[206]

Problems incumbent in the indirect methods of income reconstruction arise mainly because of the burden of proof. From the criminal standpoint, the indirect methods are troublesome because they tend to prove guilt through circumstantial evidence, even when direct evidence may be available.[207] These methods often invade the province of the jury by filling in evidentiary gaps with expert testimony, a mass of exhibits, and conclusory statements. In the end, the taxpayer must explain his way out of the circumstantial hole the government dug for him. In essence, the taxpayer must prove his innocence instead of the government proving the taxpayer's guilt beyond a reasonable doubt.[208]

With these problems in mind, the United States Supreme Court admonished trial courts to clearly instruct juries to include a summary of the indirect method, the assumptions upon which it rests, and the inferences that are available to either side.[209] The Court also advised heightened appellate court awareness of the difficulties inherent in circumstantial evidence serving as the foundation for the taxpayer's guilt.[210] Indirect methods of reconstructing income are necessary, but these methods should be exercised with considerable restraint.[211] The *Weimerskirch* court took this admonition to heart twenty-five years later. If the IRS is unwilling to use restraint when relying on a "naked assertion" in charging the taxpayer with illicit income, the court will exercise its own restraint and find for the taxpayer.[212]

---

203. *See, e.g., Kent*, 51 T.C.M. at 1607 (taxpayer found to be credible witness); *Johnson*, 41 T.C.M. at 774 (IRS witness' testimony found to be inconsistent, self-serving, and incredible).

204. *See, e.g., Kent*, 51 T.C.M. at 1605-07 (taxpayer and wife lived modestly, no evidence placing taxpayer in drug smuggling business or other illicit activity prior to episode under investigation).

205. Despite facing a deficiency notice based on income from illegal drug sales of $33 million, the taxpayer in *Jones* offered no explanation or other evidence to challenge the assessment. 903 F.2d at 1303. Although the court acknowledged the high probability that the deficiency notice was inaccurate, it held that the taxpayer failed to carry his burden because he kept no books and offered no extrinsic evidence. *Id.* at 1304.

206. *Id.* at 1306.

207. *Riganto*, 121 F. Supp. at 159.

208. *Id.* at 159-60 (citing Demetree v. United States, 207 F.2d 892, 893-94 (5th Cir. 1953)).

209. *Holland*, 348 U.S. at 129. Although *Holland* addresses only the net worth method of income reconstruction, it is the leading opinion on income reconstruction. *See also Petzoldt*, 92 T.C. at 694.

210. *Holland*, 348 U.S. at 129.

211. *Id.*

212. *Weimerskirch*, 596 F.2d at 361-62.

The Net Worth Method

The net worth method of proof is one of two traditional methods the government uses to indirectly compute taxable income.[213] Although this method is not widely used in drug cases,[214] its methodology provides the rational underpinnings for the primary methods used in drug cases.

The theory behind the net worth method is that increases or decreases in the taxpayer's net worth,[215] adjusted for nontaxable expenditures and income,[216] must result from taxable income.[217] This method has won consistent court approval in the few drug trafficking cases in which the net worth method appears.[218]

To establish a prima facie case, the IRS must prove the opening net worth figure with reasonable certainty.[219] Furthermore, the taxpayer's net worth increase must be attributable to taxable income.[220] Ideally, unreported income discovered under the net worth method is allocated to the specific year in which the unreported transaction(s) occurred. The income, however, may be averaged out over the entire examination period, because tax evasion cases do not always comply with the "niceties of the annual accounting concept."[221]

Taxpayers may refute IRS calculations by attacking either facet of the prima facie case. It is advantageous for the taxpayer to establish a high beginning net worth,[222] by proving the existence of a "cash hoard."[223] The taxpayer's credibility and lifestyle greatly impact a court's decision, because

---

213. The other method is the bank deposits method. *See* United States v. Boulet, 577 F.2d 1165, 1167 (5th Cir.), *cert. denied*, 439 U.S. 1114 (1978). For a discussion of the bank deposits method, see *infra* text accompanying notes 278-88.

214. The "cash expenditures" and "specific item" methods are more prevalent. *See* discussion *infra* text accompanying notes 236-77.

215. "Net worth" is defined as the taxpayer's total business and personal assets less the total business and personal liabilities. I.R.M., *supra* note 35, § 4231, ch. 836 (rev. 1981).

216. Nondeductible expenditures include personal living expenses, income tax payments, nondeductible portions of capital losses, and losses from the sale of personal assets, if such assets were included on the taxpayer's balance sheet. Nontaxable income includes tax-exempt interest (i.e. qualified municipal bonds), some life insurance proceeds, inheritances, gifts, and bona fide loans. *Id.*

217. The IRS recommends that its agents use this method when two or more years are under examination, or if the taxpayer had several assets and liabilities that changed during the year. *Id.*

218. *See, e.g., Lewis*, 759 F.2d at 1327.

219. *Holland*, 348 U.S. at 132. The *Holland* Court does not define "reasonable certainty," but contextually it appears to mean direct or circumstantial evidence that is sufficient to survive a directed verdict. *Id.* at 132-34. In *Holland*, the government claimed the taxpayers' net worth approximated $32,000. The Hollands claimed their net worth was $112,000, most of which was kept in a canvas bag, a suitcase, and a metal box. The government did not present any direct evidence to dispute this. Rather, it pointed to the Hollands' austere living conditions, low reported taxable income, and credit problems during the time the taxpayers claimed to have the $112,000. The jury found for the government. *Id.*

220. *Id.* at 137-38.

221. United States v. Calderon, 348 U.S. 160, 168 (1954) (evidence of taxpayer's financial history that showed increase in assets in excess of declared income deemed sufficient independent evidence for conviction of tax evasion).

222. This is because the taxable income computation is based on the difference between the beginning and ending net worth. I.R.M., *supra* note 35, § 4231, ch. 836.

223. A "cash hoard" is treated as cash that the taxpayer has on hand at the beginning of the period under examination. *See id.*

direct evidence of a cash hoard is rarely available.[224] Inconsistent testimony, as well as direct evidence contradicting the taxpayer's story, discredits the taxpayer.[225] Mere allegations of a cash hoard, therefore, are discounted in the absence of the taxpayer's positive evidentiary showing.

The taxpayer may also challenge the second net worth requirement — the calculation of taxable income. The individual must provide substantive evidence that refutes both the illegal source of the income and the agent's net worth computation.[226] The IRS did not find the actual source of income in *Kent v. Commissioner*, therefore the court held that the IRS was trying to tax the wrong person.[227] At the time Kent was arrested for drug smuggling, the authorities found that as captain of the boat, Kent was in actual possession of the boat and marijuana.[228] Although Kent was concededly smuggling drugs, the court found that his modest lifestyle did not account for the huge cash investment the drug operation needed.[229]

Unlike *Kent*, the *Johnson* court found the source of income.[230] The taxpayer simply relied on IRS computations to refute the charge of $350,000 unreported income.[231] The court, unable to locate the amount of such income from independent sources, found for the taxpayer.[232]

Drug traffickers who possess assets that cannot be explained by legitimate income are particularly prone to examination under the net worth method. Although the government need not negate every conceivable source of nontaxable income,[233] the government can make it impossible for the taxpayer to rebut its prima facie case by foreclosing all leads for legitimate sources of income.[234] It is, therefore, incumbent upon the taxpayer to offer evidence refuting the agent's calculations or the source of the income. Otherwise, if

---

224. *See, e.g., Gonzalez*, 36 T.C.M. at 983-90 (taxpayer's detailed testimony about prosperity in Cuba, ensuing escape with $325,000 after Castro came to power, and business ventures while living in the United States deemed sufficient to support cash hoard story).

225. *Wilson*, 76 T.C. at 632 (government successfully refuted taxpayer's assertion of $20,000 cash hoard, where taxpayer spent most of alleged cash hoard before examination period, taxpayer closed safe deposit box which taxpayer asserted contained money one year prior to the tax investigation, and taxpayer's admission to agent that he had no cash on hand at the beginning of the investigation).

226. Accuracy is a continuing theme in income reconstruction. *See supra* text accompanying notes 148, 149, & 200-05, and *infra* text accompanying notes 250 & 273.

227. 51 T.C.M. at 1607.

228. *Id.* at 1606.

229. The source, therefore, was an unspecified party who financed the boat's operation and planned the trip to purchase marijuana. *Id.* at 1606-07.

230. 41 T.C.M. at 771. The taxpayer was a convicted drug dealer. He properly reported the drug trafficking income on his tax return. *Id.* at 772.

231. The agent, in utilizing the net worth method, could find no appreciable increase in the taxpayer's net worth. *Id.* at 773.

232. *Id.* at 773-774.

233. *See Holland*, 348 U.S. at 137-38. All that is required is proof of a likely source of taxable income.

234. *See Lewis*, 759 F.2d at 1328. The IRS examined the drug traffickers' tax returns, expenditures and business records and found that their reported net income could not account for amassing all of their assets. *Id.* In addition, the IRS examined records of other individuals who were only tangentially related to the drug business. Lewis admitted to a government witness that he had no pre-existing legitimate source for an extremely high net worth, which consisted of eight parcels of land, two cars, a truck, a boat, assorted furniture, and $200,000 spent under assumed names. *Id.* at 1326-28.

"relevant leads are not forthcoming, the Government is not required to negate every possible source of nontaxable income, a matter peculiarly within the knowledge of the defendant."[235]

The Cash Expenditures Method

The cash expenditures method[236] is a variation of the net worth method of income reconstruction.[237] Under the cash expenditures method, the agent compares all known expenditures with all known income.[238] If the taxpayer's expenditures are greater than his reported income, and funds used to support the expenditures are unexplained, then the excess expenditures constitute unreported income.[239] Agents use this method in cases that cover only one to two tax years, where a taxpayer consumes all his income without saving his income or investing in durable property.[240] Cash expenditures is probably the most widely applied income reconstruction technique for drug cases,[241] because many drug traffickers spend a large part of their income on various living expenses, rather than investing in assets.

Taxpayers in drug trafficking cases can challenge the cash expenditures method in several ways. For example, the taxpayer can show that the IRS did not establish the beginning net worth.[242] In *Gary*, the IRS computed the taxpayer's income based on estimated drug sale profits, the cost of the seized drugs, and the taxpayer's personal expenditures.[243] The IRS failed, however, to

---

235. *Holland*, 348 U.S. at 138.

236. It is also known as the "source and application of funds" method. *See* I.R.M., *supra* note 35, § 4231 ch. 835 (rev. 1981).

237. One of the earliest cases recognizing the cash expenditures method is *Johnson*, 319 U.S. at 517.

238. I.R.M., *supra* note 35, § 4231 ch. 835 (rev. 1981).

239. *Id.* Agents use the following formula for computing taxable income under the cash expenditures method:

Application of Funds (where did it go?)			
(a) Asset increases	$xxx		
(b) Liability decreases	xxx		
(c) Nondeductible expenses	xxx		
Total		$xxx	
Less:			
Source of Funds (where did it come from?)			
(d) Asset decreases	$xxx		
(e) Liability increases	xxx		
(f) Nontaxable income	xxx		
Total:		$xxx	
Adjusted gross income as corrected:			$xxx

Income that was reported on the taxpayer's return is an additional subtraction under "Source of Funds." *Id.*

240. *Id.*

241. *See, e.g.*, *Llorente*, 649 F.2d at 152; *Petzoldt*, 92 T.C. at 661; Mack v. Commissioner, 58 T.C.M. (CCH) 89 (1989); Simeone v. Commissioner, 46 T.C.M. (CCH) 330 (1983); *Galluzzo*, 43 T.C.M. at 199; Jackson v. Commissioner, 41 T.C.M. (CCH) 1564 (1981); and *Gary*, 35 T.C.M. at 820.

242. The beginning net worth requirement can be inferred from the changes in assets component of the cash expenditures equation. *See supra* note 239.

243. 35 T.C.M. at 821. His personal expenditures were the cost of his drug habit.

determine the taxpayer's beginning net worth.[244] While this omission was not dispositive, it gave rise to serious doubts concerning the reasonableness of the income computation.[245]

The government, however, can easily overcome its failure to calculate an opening net worth figure. The figure is generally not required if the government has an otherwise strong case against the taxpayer. First, the government may meticulously investigate all other leads that suggest legitimate sources for income.[246] Second, the government may prove a likely source of illicit income.[247] Finally, courts favor the IRS if a taxpayer refuses to cooperate with the Service.[248] The general rule, therefore, is that opening net worth statements are not needed as long as the sources of funds are identified and quantified.[249]

The taxpayer can also offer proof that the government incorrectly computed his income as a defense to the cash expenditures method.[250] Courts generally require taxpayers to offer more than self-serving testimony.[251] Consequently, the taxpayer must produce substantive evidence to refute IRS calculations.[252]

In addition to sources of income, the taxpayer must also substantiate his expenditures.[253] Courts generally prefer business records supporting the taxpayer's expenditures over his own testimony.[254] Substantiation may not be sufficient, however, when the meaning of "expenditure" differs between the taxpayer and IRS. In *Mack v. Commissioner*, the taxpayer argued that cash confiscated in the drug raid should be either a business loss or business deduction.[255] The court concluded that the confiscated cash could be a business loss, but it disallowed the loss based on the strong public policy against drug trafficking.[256] Additionally, the court did not treat the cash as cost of goods sold because the cash had not yet been converted to inventory.[257] Because of

---

244. *Id.* at 822.
245. The dispositive element was that the IRS presented insufficient facts to warrant a determination that the decedent used heroin during the period under investigation. *Id.*
246. *Lewis*, 759 F.2d at 1328.
247. *See, e.g., id.* (government proved the taxpayer was involved in a lucrative, multistate drug enterprise); *Petzoldt*, 92 T.C. at 696 (testimony and drug ledgers linked taxpayer to receipt of taxable drug trafficking income).
248. *Petzoldt*, 92 T.C. at 695 (taxpayer who refused to produce books and records requested by IRS agents held accountable for any adverse procedural or evidentiary consequences that result from the declination).
249. *Id.*
250. Accuracy is a general tenet in income reconstruction cases. *See supra* text accompanying notes 148, 149, & 200-06, note 226 and accompanying text, and *infra* note 273 and accompanying text.
251. *See, e.g., Petzoldt*, 92 T.C. at 697 (taxpayer's insistence that he sold marijuana inventory at cost deemed unbelievable).
252. *See id.*
253. For statutory substantiation requirements, see I.R.C. § 274(d) (1986).
254. *See Galluzzo*, 43 T.C.M. at 211-13.
255. 58 T.C.M. (CCH) 89, 90 (1989). A § 162 business deduction is an ordinary and necessary expenditure in the taxpayer's trade or business. I.R.C. § 162(a) (1986). I.R.C. § 165 business losses, on the other hand, can be business assets sold at less than their adjusted basis, casualty, abandonment, or theft of property. I.R.C. § 165 (1986).
256. *Mack*, 58 T.C.M. at 90-91.
257. *Id.* at 91.

policy reasons similar to those in *Mack*, Congress passed I.R.C. section 280E, which denies business deductions to drug dealers.[258]

The taxpayer will prevail if he can show that the government's figures are not merely erroneous, but patently unreliable.[259] Courts generally look at additional corroborating evidence if the taxpayer alleges the IRS figures are without foundation. In *Jackson*, the only evidence that linked the taxpayer to $500,000 was the taxpayer's own statement.[260] Neither the IRS nor the police could find the cash.[261] The court, therefore, held that the taxpayer's boast that the police should have recovered $500,000 did not justify including it in the income computation.[262]

Witness credibility is crucial when the taxpayer asserts that IRS figures are unreliable. The court in *Simeone v. Commissioner* questioned a witness' explanation of the taxpayer's drug activity.[263] The court's skepticism, along with a close examination of the taxpayer's assets, convinced the court that the taxpayer was active in the drug trade.[264] The government's figures, therefore, were found to be reliable.[265]

Even though the taxpayer in *Simeone* offered weak evidence, it was better than offering no evidence whatsoever. The taxpayer in *Petzoldt* challenged the sufficiency of the entire examination, yet offered no guidance as to possible sources of nontaxable income.[266] Consequently, the court resolved any doubt against the taxpayer.[267]

Courts employ the cash expenditures method in drug trafficking cases when taxpayers consume most of their income. Taxpayers can challenge government computations by asserting that the Service's computation for the opening net worth was incorrect, or that the IRS miscalculated income by overestimating gross income or not allowing deductible expenditures. The taxpayer

---

258. I.R.C. § 280E (1986). The cost of goods sold (cost of the illicit drugs) is still allowed to be netted against the gross revenue from the sale of such drugs, in order to arrive at the taxpayer's gross profit. However, items such as salary expense, freight, rent, telephone, and bail are not deductible. *See* S. REP. NO. 494, 97th Cong., 2d Sess. 2, *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 1050.

259. *Jackson*, 41 T.C.M. at 1567. The court's term was "gross exaggeration."

260. The taxpayer taunted a law enforcement official that the drug raid had not hurt him because police had not found the $500,000 allegedly hidden in his house. *Id.* at 1565.

261. The IRS used the source and application method of income reconstruction to trace the income. The police, however, used a slightly different technique. The officers engaged in a "structural rearrangement" of the taxpayer's home. Both methods were unsuccessful. *Id.* at 1565-66.

262. *Id.* at 1565-67.

263. Simeone's co-conspirator testified that he and the taxpayer purchased cocaine to expose corrupt Bahamian officials, not to profit from illegal drug transactions. 46 T.C.M. at 333.

264. The assets included several airplanes, automobiles, and a personal residence all purchased with cash. The police also found a huge cash hoard and several loaded guns in the taxpayer's house. *Id.*

265. *Id.* at 334.

266. Petzoldt filed no tax returns for several years, and reported only nominal income for the few years that he filed tax returns. Additionally, the court had no evidence of a cash hoard or a substantial accumulation of assets before the investigation period. *Petzoldt*, 92 T.C. at 696.

267. *Id.* at 698.

generally must rely on circumstantial evidence and testimony, because direct proof of income is rarely available.

The Specific Item Method

As opposed to the net worth and cash expenditures methods which broadly canvass the taxpayer's tax liability, the specific item method requires verification of every questionable deduction or income item impacting the tax owed.[268] In addition, the Service need not thoroughly investigate all of the taxpayer's deductions, because the deductions are peculiarly within his own knowledge.[269] The burden, therefore, rests on the taxpayer once the IRS establishes that actual income is greater than reported income.[270]

This narrow approach to income reconstruction is attractive to IRS agents. The agent can readily determine the taxpayer's income from the drugs or drug-related apparatus seized at the time of arrest,[271] instead of reconstructing income from incomplete records and circumstantial evidence.

The taxpayer can refute the IRS's finding in two ways. First, he can deny ownership of the tax-generating item in question.[272] Second, the taxpayer can challenge the government's computation.[273] If the taxpayer offers only testimony to support his claim, the court will look to other evidence for guidance.[274] It is advantageous for the taxpayer, therefore, to offer both testimony and direct evidence. In *Graff v. Commissioner*, an IRS agent based the taxpayer's income upon an erroneous police report regarding the amount of chemical drums seized.[275] Graff pointed out the erroneous assumption in the police-prepared property report, so the court purportedly revised the gross income figures downward.[276] Finally, taxpayers may not assert that income computations are incorrect because they are the result of an illegal search or

---

268. I.R.M. *supra* note 35, § 4231, ch. 810.

269. *See* United States v. Shavin, 320 F.2d 308, 312 (7th Cir.), *cert. denied*, 375 U.S. 944 (1963) (citing United States v. Bender, 218 F.2d 869, 871 (7th Cir.), *cert. denied*, 349 U.S. 920 (1955)) (government not required to investigate and consider taxpayer's expenses not included on tax return in tax fraud cases).

270. *Id.*

271. *See, e.g., Jackson*, 73 T.C. at 397 n.3 (IRS determination of gross sales based upon heroin distributed by "lieutenants" whom taxpayer supervised); *Curtis*, 59 T.C.M. at 563 (gross sales calculated by wholesale cost of cocaine seized, and dividing amount evenly between taxpayer and associate); *Graff*, 52 T.C.M. at 1027 (police detective determined amount of methaqualone manufactured from size and amount of anthranilic acid drums seized, subtracted methaqualone police confiscated, and multiplied net amount by average "going rate").

272. *See Curtis*, 59 T.C.M. at 552. The court did not accept the taxpayer's self-serving statements that he gratuitously processed an unidentified party's cocaine.

273. *See, e.g., Graff*, 57 T.C.M. at 1027. Inaccuracy is an important defense for the taxpayer. *See supra* text accompanying notes 148, 149 & 200-05, and notes 226 & 250.

274. In *Jackson*, the taxpayer flatly denied any involvement in drug trafficking. 73 T.C. at 399. Jackson insisted his only source of funds was unemployment compensation and a small loan. He stated that the seizure of $54,715 and a Cadillac "had no bearing on the issue." The court disagreed. *Id.*

275. 52 T.C.M. at 1027.

276. *Id.* at 1031. The court made what appears to be a mistake in recalculating Graff's income. *Id.* The taxpayer also contended police figures for the wholesale price of quaalude tablets were too high. *Id.* The court dismissed Graff's argument because he introduced no extrinsic evidence supporting his claim. *Id.* The court also stated that the IRS has no duty to use the lowest market price. *Id.*

seizure.[277] Thus, the specific item method is an effective tool for the IRS because of its ability to focus on specific items, particularly those items seized in the drug raid.

The Bank Deposits Method

Like the net worth method, the bank deposits method is a traditional means of income reconstruction. This method requires an analysis of the taxpayer's bank account(s), which may show unreported income deposited in the taxpayer's account.[278] This method provides leads to other income by tracing deposits to their sources.[279] The method of analysis involves matching the deposits with the taxpayer's records.[280] Amounts not accounted for probably represent unreported income.[281]

The IRS must present three elements to satisfy its prima facie case in a bank deposits investigation.[282] First, the government must show that the taxpayer engaged in an income-producing activity during the period under investigation.[283] Second, the taxpayer must make regular deposits into his bank account(s).[284] Third, the government agent must make an adequate and full investigation of all accounts in order to foreclose the possibility that the taxpayer received nontaxable income.[285]

Although the bank deposits method is one of the traditional methods of income reconstruction, it has little use in drug trafficking cases.[286] Congress recently imposed record-keeping requirements upon financial institutions to make banks less attractive to drug traffickers.[287] When the bank deposits method is employed, it is generally a supplemental investigative tool for the cash expenditures method in determining unreported cash receipts.[288]

---

277. *See Janis*, 428 U.S. at 454.
278. I.R.M., *supra* note 35, § 4231, at ch. 831.
279. *Id.*
280. The IRS instructs its agents to look for certain attributes in the deposits, including: (1) size, (2) kind (i.e. cash or check, even or odd amount), (3) frequency, (4) location of the bank on which the check was drawn, (5) loans, and (6) interbank transfers or redeposits. *Id.* ch. 832.
281. *Id.*
282. *See* United States v. Morse, 491 F.2d 149, 153 (1st Cir. 1974) (testimony of agent regarding bank deposits was unsupported by independent evidence, therefore constituted inadmissible hearsay).
283. *Id.*
284. *Id.*
285. *Id.*
286. Taxpayers involved in illegal enterprises will generally go to great lengths to conceal their income; a bank account is typically not a discrete hiding place.
287. 31 U.S.C. §§ 5311-5326 (1988). Financial institutions, among other businesses, are required to report each *cash* transaction of $10,000 or more, including deposits, withdrawals, exchanges of currency or other payment or transfer, by, through, or to the financial institution. 31 C.F.R. § 103.22 (1990). In addition, there is an anti-structuring provision that prohibits any person or persons from structuring a cash transaction to defeat the provisions of the Code. 31 C.F.R. § 103.11(n). This law was specifically designed to aid both criminal and tax investigations. 31 U.S.C. § 5311 (1988).
288. *See, e.g., Intersimone*, 53 T.C.M. at 1074; Reese v. Commissioner, 36 T.C.M. (CCH) 1665, 1668 (1977).

Miscellaneous Methods

There are several other methods of income reconstruction, including the percentage computation method[289] and the unit and volume method.[290] The percentage computation method is used when sales, cost of sales, and gross or net profit percentages and ratios are considered typical to a business.[291] Likewise, when using the unit and volume method, agents determine gross receipts by applying general price and profit figures applicable to the specific business under examination.[292] The IRS employs these statistics if they are accurate.[293] Given the covert nature of drug trafficking, however, the IRS rarely has the opportunity to use such statistics.[294]

FINANCIAL IMPACT OF TAX INVESTIGATIONS UPON DRUG TRAFFICKERS

The effect of a comprehensive tax investigation and prosecution upon a drug trafficker's financial status can be staggering. The drug trafficker must not only pay tax on his illegal income, but also must pay civil and criminal penalties, and interest as well. The following hypothetical illustrates this point.

The IRS proved through an indirect method of income reconstruction that Roseanne earned $500,000 in 1988 from sales of narcotics. She did not file an income tax return for that year, although she consistently filed returns prior to 1988. She had no records to prove her claimed deductions or to protest the assessed income. The IRS issued a deficiency notice January 1, 1990. The tax was finally paid April 15, 1991.[295] The total amount due in tax, penalties, and interest is $583,850;[296] the combined tax and assessments are greater than Roseanne's gross income.

---

289. I.R.M., *supra* note 35, § 4231, at chs. 841-43 (rev. 1981).
290. *Id.* at ch. 844.
291. *Id.* at ch. 841.
292. *Id.* at ch. 844.
293. *See, e.g., Wilson*, 76 T.C. at 630-31 (police used information from its personnel, laboratory, and a monthly Bureau of Narcotics publication to ascertain the street prices of cocaine and heroin at varying degrees of purity).
294. *See* Molefsky, *supra* note 4, at 9.
295. Assume the tax rate is 35%.
296. The total amount owing is calculated as follows:

Income tax — 35% x $500,000	$175,000
I.R.C. § 6601 interest (assume 10%): $175,000 x 10% x 3 years	52,500
§ 6651 failure to file (assume fraudulent) 75% penalty	131,250
§ 6651 failure to pay: $175,000 x .5% x 36 months	31,500
§ 6651 offset between penalties	(31,500)
§ 6651 minimum penalty	100
§ 6662 accuracy-related penalty not applicable because return not filed	0
§ 6663 fraud not applicable because return not filed	0
§ 7201 criminal tax evasion maximum fine	100,000
§ 7203 criminal failure to file a return (assume no overlap with § 7201) maximum fine	25,000
§ 7206 criminal fraud maximum fine	100,000
§ 7207 criminal fraud not applicable because return not filed	0
Total tax, penalties, and interest:	$583,850

The IRS agent may use many procedural tools if he feels that the collection of this liability is imperiled. Both termination and jeopardy assessments allow for quick assessment of taxes. In addition, if the drug trafficker does not pay his liability, the IRS uses statutory enforcement mechanisms to ensure prompt collection.[297]

It is unclear whether civil or criminal penalties deter taxpayers from acting fraudulently or negligently toward their tax liability.[298] It is obvious, however, that drug traffickers will not be able to enjoy their income from drug sales.

CONCLUSION

The government is fighting the war on drugs on many fronts. While prison sentences serve to deprive convicted drug traffickers of their liberty, tax procedure and income investigation techniques deprive drug traffickers of their profits. If the Service carefully and conscientiously uses these techniques, they will serve as effective tools to successfully prosecute drug traffickers for criminal and civil tax violations.

Income reconstruction of drug profits is helpful in two ways. First, taxation ensures that the drug trafficker will not be able to enjoy the fruits of his illicit labor upon release or parole. Second, forfeiture of drug profits to the government can provide funding for preventive and rehabilitative drug programs. The IRS must take an aggressive stance when drug trafficking convictions are so numerous, in order to help stem the supply and demand of illicit drugs in the future.

---

297. The IRS uses property liens (I.R.C. § 6321 (1986)), levy and distraint (I.R.C. § 6331 (1986)), and sales of seized property (I.R.C. § 6335 (1986)) to compel payment of delinquent tax liabilities.

298. For problems associated with deterrence and tax penalties, see generally Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).