

Criminal Tax Manual

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Updated June 2001

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32.01 **GENERALLY**

The expenditures method of proof and the net worth method of proof are essentially the same. The two computations are merely accounting variations of the same basic approach, with the expenditures method being an outgrowth of the net worth method. *United States v. Breger*, 616 F.2d 634, 635 (2d Cir. 1980); *Taglianetti v. United States*, 398 F.2d 558, 562 (1st Cir. 1968), *aff'd*, 394 U.S. 316 (1969); *United States v. Caserta*, 199 F.2d 905, 906 (3d Cir. 1952). Accordingly, in considering an expenditures case, reference should be made to Section 31.00, *supra*, which examines the net worth method of proof.

The use of the expenditures method of proof to establish unreported income was approved as early as 1943 in *United States v. Johnson*, 319 U.S. 503, 517 (1943). Subsequently, in *Caserta*, Judge Goodrich defined the expenditures method of proof as follows:

It starts with an appraisal of the taxpayer's net worth situation at the beginning of a period. He may have much or he may have nothing. If, during that period, his expenditures have exceeded the amount he has reported as income and his net worth at the end of the period is the same as it was at the beginning (or any difference accounted for), then it may be concluded that his income tax return shows less income than he has in fact received. Of course it is necessary, so far as possible, to negative nontaxable receipts by the taxpayer during the period in question.

Caserta, 199 F.2d at 907.

The expenditures method of proof tracks a taxpayer's expenditures for consumable goods and services (*i.e.*, items which do not increase one's net worth), as opposed to any acquisition of assets (*i.e.*, items such as stocks, bonds, or real estate which increase one's net worth). The expenditures method is designed to account for the taxpayer who spends his income on consumable items, such as food, vacations, travel, or gifts to third parties, which do not increase net worth. The expenditure method is distinct from the use of expenditures in an analysis of bank deposits. See, *e.g.*, *United States v. Conaway*, 11 F.3d 40, 43 (5th Cir. 1993); *United States v. Abodeely*, 801 F.2d 1020, 1024 (8th Cir. 1986);.

One advantage of using the expenditures method of proof, rather than the net worth method, is well summarized by the *Taglianetti* court:

The government proceeded on a "cash expenditure" theory. This is a variant of the net worth method of establishing unreported taxable income. Both proceed by indirection to overcome the absence of direct proof. The net worth method involves the ascertaining of a taxpayer's net worth positions at the beginning and end of a tax period, and deriving that part of any increase not attributable to reported income. This method, while effective against taxpayers who channel their income into investment or durable property, is unavailing against the taxpayer who consumes his self-determined tax free dollars during the year and winds up no wealthier than before. The cash expenditure method is devised to reach such a taxpayer by establishing the amount of his purchases of goods and services which are not attributable to the resources at hand at the beginning of the year or to non-taxable receipts during the year.

Taglianetti, 398 F.2d at 562 (footnotes omitted).

32.02 REQUIREMENTS FOR ESTABLISHING AN EXPENDITURES CASE

The requirements for establishing an expenditures case are virtually identical to those required for establishing a net worth case. Thus, in an expenditures case, the government must:

1. Establish an opening net worth with reasonable certainty and demonstrate that the taxpayer's expenditures did not result from cash on hand, or the conversion of assets on hand at the beginning of the period;
2. Establish through independent evidence that the expenditures charged to the taxpayer are non-deductible;
3. Establish a likely source of income from which the expenditures sprang, or negate nontaxable sources of income; and
4. Investigate all relevant, reasonable leads which are reasonably susceptible of being checked.

Taglianetti v. United States, 398 F.2d 558, 562 (1st Cir. 1968), *aff'd*, 394 U.S. 316 (1969) (cited in *United States v. Sutherland*, 929 F.2d 765, 780 (1st Cir. 1991)); *United States v. Caswell*, 825 F.2d 1228, 1231 (8th Cir. 1987); *United States v. Mastropieri*, 685 F.2d 776, 778 n.2 (2d Cir. 1982); *United States v. Breger*, 616 F.2d 634, 635 (2d Cir. 1980); *United States v. Gay*, 567 F.2d 1206, 1207 (2d Cir. 1978); *United States v. Marshall*, 557 F.2d 527, 529 (5th Cir. 1977); *United States v. Bianco*, 534 F.2d 501, 504 (2d Cir. 1976); *United States v. Fisher*, 518 F.2d 836, 841-42 (2d Cir. 1975); *United States v. Newman*, 468 F.2d 791, 793 (5th Cir. 1972); *United States v. Penosi*, 452 F.2d 217, 220 (5th Cir. 1971); *McFee v. United States*, 206 F.2d 872, 874 (9th Cir. 1953), *vacated and remanded*, 348 U.S. 905, *aff'd upon reconsideration per curiam*, 221 F.2d 807 (9th Cir. 1955); *United States v. Caserta*, 199 F.2d 905, 907 (3d Cir. 1952); *see also United States v. Pinto*, 838 F.2d 426, 431-32 (10th Cir. 1988); *United States v. Marrinson*, 832 F.2d 1465, 1469-70 (7th Cir. 1987); *United States v. Citron*, 783 F.2d 307, 315 (2d Cir. 1986), *rev'd on other grounds*, 853 F.2d 1055 (2d Cir. 1988); *United States v. Radseck*, 718 F.2d 233, 237-38 (7th Cir. 1983).

Reference should be made to Section 31.00, *supra*, in which the net worth method of proof is discussed.

32.03 CONCEPTS APPLICABLE TO EXPENDITURES CASES

As noted above, the government has essentially the same burden in an expenditures case that it has in a net worth case. There are, however, a few wrinkles which should be mentioned.

32.03[1] Opening Net Worth

The requirement that the government must establish the defendant's opening net worth with reasonable certainty is derived from *Holland v. United States*, 348 U.S. 121, 132, (1954). However, the government's method of proving an expenditures case is slightly different from the net worth method employed in *Holland*. This distinction was examined by the *Taglianetti* court:

In a typical net worth case, as *Holland*, precise figures would have to be attached to opening and closing net worth positions for each of the taxable years to provide a basis for the critical subtraction. In a cash expenditures case reasonable certainty may be established without such a presentation, as long as the proof . . . makes clear the extent of any contribution which beginning resources or a diminution of resources over time could have made to expenditures.

Taglianetti, 398 F.2d 558, 565 (1st Cir. 1968), *aff'd*, 394 U.S. 316 (1969).

Thus, the government must prove not only that yearly expenditures exceeded reported income, but also, either directly or inferentially, that those expenditures were made with currently taxable income. Unless both requirements are met, a conviction cannot stand. See, e.g., *United States v. Marshall*, 557 F.2d 527, 529 (5th Cir. 1977). Thus, the government must present evidence indicating that the defendant did not liquidate assets acquired in a previous year or deplete a cash hoard to make the expenditures in issue.

Once the government establishes a starting point for the first prosecution year, it should then proceed to compute the total taxable and nontaxable receipts for each of the following consecutive years to prove its case. *Marshall*, 557 F.2d at 530. In *United States v. Bianco*, 534 F.2d 501, 504 (2d Cir. 1976), the government attempted to show that Bianco's beginning resources were nonexistent, and thus, could not have contributed at all to his expenditures during the tax years. The court described the extensive investigation by the government into Bianco's financial background, and concluded that the "totality of this evidence clearly was sufficient for the jury to have concluded that Bianco had insufficient assets at the beginning of the prosecution period to have supported his expenditures in any of those years." *Bianco*, 534 F.2d at 505. See also *United States v. Fisher*, 518 F.2d 836, 841-42 (2d Cir. 1975) (government introduced evidence that Fisher had \$30,000 in bank accounts and that this constituted all of the assets that Fisher and his wife possessed).

It is not necessary in an expenditures case, as it is in a net worth analysis, to reflect the opening and closing net worth position of the taxpayer in a formal net worth statement. Thus, reasonable certainty may be established without such a presentation, as long as the expenditures analysis takes into account the extent of any contribution, which beginning resources or a diminution of resources over time, could have made to the expenditures during the prosecution years. *Taglianetti*, 398 F.2d at 565. In a footnote, the *Taglianetti* court discussed various expenditures cases and the absence of any requirement of a formal net worth statement. *Taglianetti*, 398 F.2d at 565 n.7.

32.03[2] Cash on Hand

Formal proof of a net worth is not required in an expenditures case. See *United States v. Conaway*, 11 F.3d 40, 43 (5th Cir. 1993). Establishment of cash on hand, however, is essential and recognized to be the most difficult component of proof in such tax prosecutions. See *United States v. Citron*, 783 F.2d 307, 316 (2d Cir. 1986), *rev'd on other grounds*, 853 F.2d 1055 (2d Cir. 1988) (an agent's investigation into the truth of a cash hoard defense was sufficient in establishing cash on hand). In *Citron*, however, the Second Circuit reversed the convictions because the District Court admitted into evidence a summary chart containing figures not demonstrably supported by the evidence. *Citron*, 783 F.2d at 317.

32.03[3] Cash Hoard Defense

Similar to net worth cases, a cash hoard defense is frequently raised in expenditures cases. To assert a cash hoard defense, the taxpayer contends that expenditures during the relevant years were made with previously accumulated funds (cash on hand) and not with currently taxable receipts. See Sections 31.06 and 31.07, *supra*.

In *United States v. Radseck*, 718 F.2d 233, 239 (7th Cir. 1983), the government rebutted a cash hoard defense with testimony from the special agent "that in his experience in investigating thirty-five to forty attempted income tax evasion cases, people who have five bank accounts, thirteen savings and loan accounts and two brokerage accounts do not keep substantial amounts of cash on hand." The court found that the inference that the defendant did not keep cash at home was a permissible one.

In *United States v. Gay*, 567 F.2d 1206, 1207 (2d Cir. 1978), the defendant testified at trial that he had a cash hoard of more than \$100,000 in spite of the fact that he had told the investigating agents that he and his wife had no more than \$13,000. The \$13,000 figure was used in the opening net worth computation. The court stated that "the jury was entitled to infer, as it apparently did, that appellant's 'cash hoard' testimony was a belated and blatant concoction which was not entitled to any credit." *Gay*, 567 F.2d at 1207.

32.03[4] Duplication of Expenditures

In establishing a taxpayer's expenditures, care must be taken to insure against a duplication of expenditures. In *United States v. Caserta*, 199 F.2d 905, 907 (3d Cir. 1952), a new trial was ordered because a duplication resulted from the defendant being charged with both cash withdrawals from a bank account and expenditures for individual items since the evidence did not establish that the cash withdrawals were not applied to the cash purchases. For an excellent and detailed explanation of such an error, see the opinion of Judge Goodrich in *Caserta*, 199 F.2d at 906-08. *Cf. United States v. Radseck*, 718 F.2d 233, 238 (7th Cir. 1988) (the duplication of \$2,766 as both a personal expenditure and an increase in assets did not render the government summary exhibits inadmissible because this error and others were revealed to the jury during cross-examination of the government's summary witness and acknowledged by the government during closing argument).

32.03[5] Likely Source of Income

In an expenditures case, as in a net worth case, the government must establish a likely source of taxable income, or eliminate the possibility that the cash expenditures were made with nontaxable sources of income. See, e.g., *United States v. Marrinson*, 832 F.2d 1465, 1472 (7th Cir. 1987); *United States v. Bianco*, 534 F.2d 501, 506-07 (2d Cir. 1976). Therefore, from a purely legal standpoint, the government need not negate nontaxable sources when it has already established a likely source of taxable income. However, as a matter of trial strategy, it is

advisable not only to establish a likely source of taxable income, but also to eliminate any nontaxable sources for the funds. Such an approach makes a good impression on both judge and jury. This does not mean that unreasonable efforts need to be expended, however, since "once expenditures are established, the government cannot be expected to conduct an exhaustive nationwide investigation when the defendant supplies no relevant leads as to where he got the money he admittedly spent." *United States v. Penosi*, 452 F.2d 217, 220 (5th Cir. 1971). See also Section 31.12, *supra*. Yet, if the investigation can include both approaches, the government's case will be that much stronger.

32.03[6] Summary Exhibits

In an expenditures case, the government is not required to include the defendant's version of the facts in its summary exhibits. *United States v. Radseck*, 718 F.2d 233, 239 (7th Cir. 1983). This is also true in net worth cases. See Section 31.14, *supra*.

32.04 JURY INSTRUCTIONS

In an expenditures case, as in a net worth case, it is essential that the charge to the jury "should be especially clear, including, in addition to the formal instructions, a summary of the nature of the net worth [expenditures] method and the assumptions on which it rests, and the inferences available both for and against the accused." *Holland v. United States*, 348 U.S. 121, 129 (1954). Accord *United States v. Hall*, 650 F.2d 994, 998 (9th Cir. 1981); *United States v. Tolbert*, 367 F.2d 778, 780-81 (7th Cir. 1966); *United States v. O'Connor*, 237 F.2d 466, 472-73 (2d Cir. 1956). See also *United States v. Meriwether*, 440 F.2d 753, 756-57 (5th Cir. 1971) (reversing section 7201 conviction because trial court failed to instruct jury on method of proof).

A conviction on one count was reversed in *United States v. Carter*, 721 F.2d 1514 (11th Cir. 1984), where the court held that it was plain error to fail to instruct the jury on the expenditures method of proof:

We find that the omission of the required explanatory instructions concerning the cash expenditures method of proof in this case "goes to the very basis of the jury's ability to evaluate the evidence," *Hall*, 650 F.2d at 999 [*United States v. Hall*, 650 F.2d 994 (9th Cir. 1981)], and to the very core of the deliberative process necessary to guarantee the fairness of the proceedings. We therefore hold that the omission of the explanatory instructions required by *Holland* concerning the cash expenditure method of proof constituted plain error affecting appellant's substantial rights.

Carter, 721 F.2d at 1539 (citations omitted).

therefore hold that the omission of the explanatory instructions required by *Holland* concerning the cash expenditure method of proof constituted plain error affecting appellant's substantial rights.

Carter, 721 F.2d at 1539 (citations omitted).