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The Income Tax and Accounting Records for Illegal Businesses

Thomas J. Whiting

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The Income Tax and Accounting Records for Illegal Businesses

*by Thomas J. Whiting**

THE ACTIVITIES OF GAMBLERS and other illegal operators have received considerable public notice recently as a result of the Kefauver Committee's investigations. Although the amounts of money involved in these operations are astronomical, no complete records are maintained by these individuals. Amounts entered on income tax returns of this type are completely incapable of verification in the usual method because of the incompleteness of the records and data available. Admittedly these operators are in the unenviable position of being required to keep complete records for income tax purposes, but being afraid to do so because of their evidentiary value to state and local authorities. However, the courts seem to have taken a lenient attitude concerning the requirements for the keeping of records as they are applied to taxpayers engaged in illegal businesses. This attitude is illustrated by the decision in the case of *Leonard Cephus Hall vs. Commissioner.*[1]

In that case the petitioners operated as bankers of "numbers lotteries" in Nashville, Tennessee. Writers, persons receiving wagers from customers, received as commissions thirty percent of the bets placed; and pickup men, persons collecting from several writers, were allowed seven percent of each bet. Only the net—gross bets less the allowable commissions—were turned over to petitioners. The amount so received was totaled and expenses recorded. The original bet slips were retained one week and then destroyed, allegedly, because of the fear of seizure by local authorities as evidence. Each Monday these daily summaries were totaled and this weekly summary given to the accountant. From these, monthly tally sheets were prepared by the accountant. The petitioners' income tax returns were prepared from these monthly tally sheets, and these sheets were

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1 Leonard Cephus Hall vs. Commissioner, Memo Tax Court Decision.

made available to the examining revenue agents. The gross take so recorded therefore amounted to sixty-three percent of the gross bets. The deficiency was determined by taking the gross take and thereby projecting the gross bets. The hits, payouts to winning players, were then limited to fifty percent of the projected gross bets, thereby disallowing as a deduction the hits in excess of fifty percent of the gross bets.

The court held that a taxpayer's net income shall be determined or computed in accordance with the method of accounting which he regularly employs. The Commissioner also has the right to compute a taxpayer's income by any method which in his opinion clearly reflects his income, if the taxpayer keeps no books or records, or if those kept do not clearly reflect his income. Pursuant to the authority of Section 41 of the Internal Revenue Code, the respondent had determined payouts in wins to be less than those shown in the records. The mathematical hypothesis on which respondent has attempted to establish a fifty percent ratio between hits and total bets for numbers operators offering odds of five hundred to one is at best little more than imaginary. The respondent's determination of deficiencies was arbitrary and without authority.

The first question presented by the facts in the *Hall* case is whether or not illegally obtained income is taxable to the recipient. Gross income includes gains or profits and income derived from any source whatever.[2] It is apparent therefore that the illegality of the business from which profits arise is immaterial in determining tax liability. This intent, in addition to the above all inclusive scope of gross income, is implied by the requirements prescribing the manner and by whom income tax returns may be inspected. The effect is to make the information revealed on income tax returns confidential, and it may only be revealed to state tax authorities under certain prescribed rules.[3] Penalties are also provided for any unauthorized disclosures of information contained in income tax returns.[4] The only apparent reason for these precautions is to encourage full disclosure of income, source, and other required information. These regulations pro-

[2] Internal Revenue Code, Section 22(a); Income Tax Regulations 118, Section 39.22(a).

[3] Internal Revenue Code, Section 55(b); Income Tax Regulations 118, Section 39.55, Section 39.55-1.

[4] Internal Revenue Code, Section 55(f).

vide specifically for disclosure to state authorities, which is of particular interest to those engaged in illegal activities.

The basic issue involved in this case is the adequacy or inadequacy of the taxpayer's records. Section 41 of the Internal Revenue Code provides as follows:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect income.

Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.[5] It is recognized that no uniform method of accounting can be prescribed for all taxpayers and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are, in his judgment, best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so.[6]

Section 54 of the Internal Revenue Code provides as follows:

> Every person liable to any tax imposed by this chapter or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations as the Commissioner may from time to time prescribe.

Every person subject to the tax, except persons whose gross income consists solely of salary, wages or similar compensation for personal service, or arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account, including inventories as are sufficient to establish the amount of gross income, and the deductions, credits, or other matters required to be shown in any return.[7]

These two sections prescribe for the keeping of records and give a clear indication as to the type of records required. They require that gross income, deductions, and credits be shown

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[5] Income Tax Regulations 118, Section 39.41-2.

[6] Income Tax Regulations 118, Section 39.41-3.

[7] Income Tax Regulations 118, Section 39.54-1.

therein. They also specifically require that they be of such form as to enable the Commissioner to determine the income subject to the tax.[8] Standard accounting methods will clearly reflect income. Records prepared by standard accounting methods and procedures require reference to receipts, cancelled checks, sales slips, cash register tapes or readings and like data for verification. Any accepted method of auditing requires reference and examination of basic data, not merely a recomputation of recorded amounts.[9]

In the *Hall* case all basic data was destroyed, purportedly in fear of seizure by the Tennessee state authorities as evidence. This destruction leaves records which are incapable of verification, since any verification would require reference and examination of the basic data, namely: bet tickets and tapes.

The court stated, "We are not unmindful, of course, that petitioner could have correctly reported the gross intake and expenses, and could have consistently overstated the amount of wins, as respondent apparently thinks was the case. We can also appreciate the respondents disposition to think that one engaged in a business declared illegal under state law might be more apt to incorrectly report his income than one who earned his livelihood in some manner of which society approved. And we also think respondents' conclusion that a secondary reason for petitioner's destruction of the individual-player tickets was to avoid payment of correct income tax is not wholly unreasonable." [10]

The destruction of the basic records leaves the agent with little with which to work. No detailed audit can be made because of the lack of basic records.[11] The agent's basic job is to verify[12] reported income. This can't be done directly without examination of the original tickets. Therefore the methods of keeping records by the taxpayer did not result in records which were adequate or capable of verification.

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[8] Income Tax Regulations 118, Section 39.54-1.

[9] *Auditing, An Introduction* by E. L. Kohler.

[10] L. C. Hall vs. Commissioner.

[11] *Auditing, An Introduction* by E. L. Kohler, pg. 174—"The purpose of a detailed audit is to review original transactions for the authenticity, clerical accuracy, and completeness with such attention to classification as the occasion demands."

[12] *Auditing, An Introduction* by E. L. Kohler, pg. 23—"Verify: to confirm the accuracy of, by competent examination."

When records are inadequate the Commissioner has authority to determine income. This is generally done by either the net-worth[13] or a bank deposits[14] method. There are numerous decisions supporting income determination by these methods. A net-worth could not be used because of the difficulty of accurately determining a starting point. Cases involving racketeers are difficult to prove. Gamblers and gangsters do not keep books to show their receipt of income. Therefore, it is usually necessary for the Government to rely on their year-by-year increases in net worth and their known expenditures. To make this type of proof stick in court we must establish a beginning point from which to figure annual increases in wealth. And because these characters must hide their activities it is always difficult and sometimes impossible to establish a starting net worth which excludes the possibility of other hidden wealth.

In the *Hall* case payouts were limited to fifty percent of the gross bets. Of this the court held it was at best little more than an imaginary hypothesis, and therefore arbitrary.

The mathematical hypothesis of this determination is based upon the laws of probability. In spite of the courts' dim view of these laws one of the country's largest businesses, life insurance, is predicated on these laws. The structure of life insurance depends fundamentally on three elements: (a) the probability of the death of a given individual in a given period of time, (b) the interest rate which can be earned on invested funds, and (c) the rate of expense incurred in the sale and maintenance of a life insurance policy.[15] As a consequence the laws of probability are of great importance to life insurance companies and their ability to operate profitably. That these laws have been solved mathematically is evidenced by the profitable operation and tremendous growth of these companies.

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[13] A net-worth method is a method in which income is determined by the increase in the excess of assets over liabilities during the year in question, with adjustments for items not reflected on the balance sheet. The essential requirement is to establish the net-worth at the beginning of the period with certainty.

[14] An income determination method which utilizes bank deposits (total) plus cash expenditures with adjustments for transfers between bank accounts or other duplications.

J. V. Moriarty vs. Commissioner, 18 T. C. 327—Bank deposits method upheld on numbers operator where no return was filed.

[15] An Introduction To The Mathematics of Life Insurance—Menge & Glover, pg. 1.

Some of the basic laws of probability are: If an event can happen in (h) ways and fail in (f) ways, all of which are equally likely, the probability (p) of the occurrence of the event is

$$(1) \qquad p = \frac{h}{h + f}$$

and the probability of the failure of the event (q) is

$$(2) \qquad q = \frac{f}{h + f}$$

This mathematical definition gives a precise meaning to the words chance or probability as used in regard to the occurrence of an event. Thus if a bag is known to contain ten balls, seven of which are white and the other three black, the probability that a ball drawn at random will be white is 7/10. In this problem $h = 7$ while $f = 3$.

From definitions (1) and (2) it is obvious that p and q are both less than or equal to unity while their sum is

$$p + q = \frac{h + f}{h + f} = 1$$

Thus the probability of the occurrence of an event plus the probability of the failure is equal to unity. In other words, failure plus success is certainty. Furthermore when $f = 0$, $p = 1$, and hence if an event is certain to occur the probability of its occurrence is unity.[16]

In numbers operations there are one thousand possible numbers (000-999) only one of which is a winner. Therefore the chances of selecting that one number is one in one thousand. To the winner odds are paid 500 to 1; therefore the payouts for each $1,000.00 bet would be $500.00. That courts have recognized this is evident by the following: "As the game was played, the odds against the player were about 1000 to 1 and the winnings paid on the basis of 600 to 1. Appellant had a margin of $400.00 out of every $1,000.00 played."[17] Applying the conclusion of the *Miro* case, where an operator only paid 500 to 1 the payouts would only equal fifty percent of the gross bets.

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[16] An Introduction To The Mathematics of Life Insurance—Menge & Glover, pg. 2.

[17] United States vs. Miro, 60 F. (2d) 58, 59.
In this case winners were paid 600 to 1. This is a criminal case for failure to file and tax evasion.

True, probability is not a certainty, and payouts may exceed fifty percent in any given year but they would not consistently exceed fifty percent year after year. Payouts would tend to approach fifty percent as a limit, and over several years would very closely approximate it. A numbers operation is predicated on chance and it seems that chance would operate here, as it does in the insurance business, to validate the known mathematical theorems.

The last important issue in the *Hall* case is that of burden of proof. The taxpayer has the initial burden of substantiating amounts stated on the tax return itself. "In order to support a claimed deduction for business expenses a taxpayer must be able to establish his right under law to the deduction, and be in a position to furnish proof of the expenditure." [18] In order for the taxpayer to meet this burden detailed data should be available as to date paid, person paid, amount paid, and the reason for the expenditure. The records in the instant case could only establish the total amounts paid monthly. In connection with establishing that payouts were actually paid, the taxpayers failed to comply with Section 147 of the Internal Revenue Code which requires information returns for payments which exceed $600.00 during the year. Since it appears that the pickup men were considered independent contractors, forms 1099 should have been issued showing the amount of winnings paid to each during the year. Had the taxpayer complied with this requirement he would have, at least, established some evidence that the expenditures were actually made.

The second burden imposed upon the taxpayer is that of overcoming the presumption of correctness of the Commissioner's determination.[19] Judge Rice in reference thereto stated that petitioner's meticulous system of transcribing daily, weekly, and monthly statements of his operations over a twelve year period, albeit he destroyed the original player tickets, could just as logically support the conclusion that while he made every effort to prevent the discovery of evidence which would be useful in

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[18] Prentice-Hall Tax Service, 1954 Volume 2, Paragraph 11,342.

[19] Rogers et ux vs. Comm., 11 F. (2d) 987, "The findings of the Commissioner is prima facie correct and petitioners have the burden of proving what of the determined to be deficiency is not due."
Welch vs. Helvering, 290 U. S. 111;
U. S. vs. Peabody Co., 104 F. (2d) 267;
Com. vs. Volunteer State Life Insurance Co., 110 F. (2) 879.

prosecution under Tennessee law, he has made a studied effort to avoid intentional violation of the income tax laws. The alternative conclusion of the court may be a logical conclusion from the facts presented. However, it does not appear that because an alternative conclusion is available is, in itself, enough to sustain the burden of proving the Commissioner's determination in error. The burden imposed upon the taxpayer is to prove the Commissioner in error, not merely that another result can be reached from the facts presented. The court in the *Hall* case gave considerable weight to the taxpayer's testimony, which was self-serving testimony, supported by inadequate records. This burden is imposed purposefully because, "Implicit in the working of the system is an obvious duty of keeping proper records imposed on the taxpayer." [20] Our income tax system is basically self-assessment, and for the government to receive the proper revenue honest reporting is required of the taxpayer. The usual method of verifying a return is to audit the books and records. Since the records of this taxpayer, as are those of most professional gamblers and other illegal operators, were incapable of verification some other method had to be used. If the only method available to the Commissioner to verify this self-assessment is to audit the books and records, to avoid payment of the proper tax one need merely to have no books or records available for audit. This would defeat the tax as well as the sections requiring that adequate records be maintained. The records maintained by illegal operators are little better than no records at all.

The determination made by the Commissioner, in substance, was a mark-up method which has been upheld in numerous decisions.[21] A mark-up method is a method of verifying gross profit. These methods are based upon statistical knowledge of the gross profit rate earned by various types of businesses. This permits an experienced auditor to determine from purchases what sales should have been, or conversely from sales what purchases should

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[20] Halle vs. Commissioner, 175 F. (2d) 500.

[21] Decisions upholding income determination by use of markup:
A. S. Schwartz, 12 TCM 430, Restaurant;
Banfield, 1 BTA 665, Dealer in Stamps;
Bishoff, 27 F. (2d) 91, Retail Grocery;
Welsch, 2 BTA 64, Importing and Renovating Feathers;
Yorkville Poultry, 18 BTA 47, Poultry;
Ginzburg, 14 BTA 324, Publishing and Printing;
Rubin, Inc., 10 BTA 866, Restaurant.

be. Generally purchases may be verified more easily than sales. This determination is frequently used by accountants, both public and employee, to determine management's efficiency as to pricing and internal control.

For example, let us assume Smith operates an appliance store. Let us further assume that an appliance store of this type works on a margin of 20% of sales price. Smith's cost of sales is $200,000.00 and sales are $220,000.00. Smith, therefore, has a gross profit of $20,000.00 or 9% of sales. Immediately an auditor would seek to determine why Smith's sales aren't approximately $250,000.00. Some discernible reason should be found for this discrepancy regardless of the net profit or loss. This verification has widespread use because all of the amounts shown on the books can be examined and substantiated. That is: cost of sales are verifiable, checks or receipts are available for all expenses, and recorded sales are verified by cash register tapes. In spite of this, there may be no other way of determining whether all the sales have been recorded. An analysis of this ratio may discover an understatement of sales, or purchases and sales. For this reason this ratio is a valuable tool to independent auditors, because it may discover unrecorded sales and profits.

In the *Hall* case a method was used which, in effect, results in the probable gross profit, and is thereby essentially a mark-up basis. Since the expenses of an operation of that kind are small and easily checked, except the payouts to winners, any substantial concealment of income would have to be either by increasing payouts claimed, reducing the gross play, or both. That is, it would directly adjust the correct gross profit. The Commissioner, realizing gross profit in this type of operation should approximate fifty percent of the gross play, payouts were limited by him to fifty percent, thereby making the gross profit fifty percent. There is no reason to assume any concealment of income was made by increasing payouts rather than reducing sales; however, since the taxpayer is unable to verify either figure, it appears the Commissioner can properly use either as a working assumption. The mere fact that the one assumed correct cannot be conclusively established is not fatal, because the taxpayer can prove neither amount except by his own testimony. Further, by his own testimony, the taxpayer has also contended that the gross play is that which the Commissioner has assumed to be correct. Therefore how can the taxpayer complain because the Commis-

sioner has accepted one of his figures as correct and has asked the taxpayer to prove another. In the course of any examination many figures are accepted without serious question whereas others are questioned in detail, and conclusive proof requested.

There does not appear to be any reason for not upholding this method against an illegal operation whereas it has frequently been upheld against legal operations. Further, this Court in its decision seemed to put a greater burden upon legal business activities to keep adequate and complete records than it would impose upon illegal operators. Legitimate businesses must keep many additional records just for tax purposes, whereas this Court indicates that illegal businesses need only keep summary or memo records, the primary distinction being the type of business being conducted. Railroads and other public carriers are greatly burdened by the necessity of collecting and reporting the excise tax on the transportation of persons and property. In fact, most excise taxes, as well as withholding tax and other payroll taxes, impose additional expense upon the taxpayer without any compensation, additional consideration or other relief. If these businesses can be required to incur additional expense and inconvenience just for tax purposes, there appears no sound basis for granting relief from the requirement of keeping records merely because one is engaged in illegal activities.

Legal businesses are required to maintain adequate and complete records or they become liable for additional taxes by income determinations by any of the foregoing methods. Yet this Court says that the illegal operator should not have this burden because of their fear of seizure. This possibility of seizure would appear to be one of the risks assumed by the taxpayer when he decided to engage in that type of enterprise.

True, legal businesses would require many of such records for internal control and other management purposes, but this should not affect the requirements for income tax purposes. It may also be true that businesses destroy basic records because of fear of their seizure as evidence, but here again this should not affect the requirements for income tax purposes. There appears no logical reason for considering the motives involved.

To assume that those engaged in illegal operations are any more conscientious about complying with income tax laws than they are about obeying other laws is absurd. In fact, it was said by the Kefauver Committee in their report that it is apparent

that many, if not all, of the returns submitted for the gamblers and gangsters are fraudulent and that the Government is losing huge sums in tax revenues from the illegal ventures run by them.[22] Internal Revenue, as was this senate investigation, is hampered by the lack of records.[23]

Although the method of determining income used by the Commissioner was not ideal, it was the best method available under the circumstances. The petitioner has not met his initial burden of substantiating the amounts reported on the return. The taxpayer was unable to substantiate any deduction for hits. However, since it was realized that there must have been some, a deduction for the probable amount was allowed. The fact that this amount cannot be determined with certainty is not fatal.[24] That the records were incomplete and inadequate was conclusive, and a presentation by the petitioner of an alternative conclusion should not be sufficient to support his burden of overcoming the Commissioner's presumption of correctness.

This Court held in effect that because the taxpayer was afraid that his records would be seized by state authorities, complete records were not required for income tax purposes. The Internal Revenue Code makes no distinction between illegal and legal businesses and there should be no distinction as concerns the enforcement of it. Certainly business men should not be discriminated against because they chose to enter legitimate businesses. Income determination based on bank deposits, net-worth increase, and mark-up have frequently been upheld by the courts against legitimate business men. The courts have also consistently upheld the disallowance of unsubstantiated business expenses, and an allowance of an approximation, as a deduction. There is no reason to make an exception because one is engaged in illegal business. These men entered these operations fully knowing the requirements of the state and federal statutes, the burdens they imposed, and risks involved in their violation; they therefore chose to assume them. They should not now be heard to complain, and be given relief.

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22 82nd Congress First Session, Senate Report No. 307, pg. 9.

23 82nd Congress First Session, Senate Report No. 307, pg. 10.

24 Cohan vs. Commissioner.