Arcelo Reproduction Co. , Inc. v. Commissioner, T. C. Memo. 1991-638

The bank deposits method is a valid means of reconstructing income for tax fraud cases when taxpayers fail to maintain adequate records.

Summary

The U. S. Tax Court upheld the use of the bank deposits method to reconstruct income in a case involving Arcelo Reproduction Co. , Inc. , and its shareholders, Walter Mycek and Joseph DiLeo, who were convicted of tax evasion. The court found that the company and its shareholders had underreported income by diverting corporate funds into secret bank accounts. The bank deposits method was used to prove the underreported income and establish fraud. The court also determined that the statute of limitations did not bar the assessments due to the fraudulent nature of the returns. This case highlights the importance of maintaining accurate records and the implications of failing to report all income, especially in cases of suspected tax evasion.

Facts

From 1978 to 1982, Arcelo Reproduction Co. , Inc. , engaged in the printing and lithography business, with Mycek and DiLeo each owning 50% of the stock and serving as president and secretary/treasurer, respectively. They opened several secret bank accounts where they deposited a portion of Arcelo's gross receipts. These funds were not reported on Arcelo's corporate tax returns. Mycek and DiLeo also withdrew funds from these accounts for personal use without reporting them on their individual tax returns. Both were later convicted of conspiring to evade taxes and filing false tax returns.

Procedural History

The Commissioner of Internal Revenue issued notices of deficiency to Arcelo, Mycek, and DiLeo for the years 1978 through 1982. The taxpayers petitioned the U. S. Tax Court for a redetermination of the deficiencies. The court found in favor of the Commissioner, using the bank deposits method to reconstruct income and establish fraud, and upheld the assessments.

Issue(s)

1. Whether Arcelo, Mycek, and DiLeo understated their income tax in the amounts determined by the Commissioner.
2. Whether Arcelo, Mycek, and DiLeo are liable for additions to tax for fraud under section 6653(b).
3. Whether Arcelo is liable for an addition to tax under section 6661 for 1982.
4. Whether the statute of limitations bars the assessment of the income tax deficiencies.
5. Whether Michele Mycek and Mary DiLeo are entitled to relief as innocent spouses

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under section 6013(e).
6. Whether the use of a special agent who participated in the grand jury investigation in the civil case violated rule 6(e) of the Federal Rules of Criminal Procedure or gave the Commissioner an unfair discovery advantage.

Holding

1. Yes, because the bank deposits method established that Arcelo, Mycek, and DiLeo did not report all income received.
2. Yes, because clear and convincing evidence showed that the underpayments were due to fraud.
3. Yes, because Arcelo substantially understated its income tax for 1982.
4. No, because the fraudulent nature of the returns allowed for assessment at any time under section 6501(c)(1).
5. No, because the issue was raised untimely and the taxpayers did not meet their burden of proof.
6. No, because the special agent's limited role did not violate rule 6(e) or provide an unfair discovery advantage.

Court's Reasoning

The court applied the bank deposits method to reconstruct income due to the lack of adequate records maintained by the taxpayers. The method assumes all bank deposits represent taxable income unless proven otherwise. The court found that the taxpayers did not challenge the computational accuracy of the method, and thus, the underreported income was established. The court also relied on the criminal convictions of Mycek and DiLeo for tax evasion as collateral estoppel for civil fraud under section 6653(b). The court rejected the taxpayers' arguments about the statute of limitations, as the fraudulent nature of the returns allowed for assessments at any time. The court also dismissed the innocent spouse claims due to untimely raising of the issue and lack of evidence. Finally, the court found no violation of rule 6(e) or unfair discovery advantage from the special agent's limited role in the civil case.

Practical Implications

This case reinforces the validity of the bank deposits method for reconstructing income in tax fraud cases, particularly when taxpayers fail to maintain adequate records. Tax practitioners should be aware that the burden of proof remains on the taxpayer to challenge the accuracy of the method. The case also highlights the importance of reporting all income and maintaining accurate records to avoid fraud penalties. The use of secret bank accounts and failure to report income can lead to criminal convictions and civil fraud penalties. Additionally, this case underscores that the statute of limitations does not apply to fraudulent returns, allowing the IRS to assess taxes at any time. Finally, the case clarifies that limited participation by a special agent from a criminal investigation in a civil case does not necessarily violate

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rule 6(e) or create an unfair discovery advantage.

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