DiLeo v. Commissioner, 96 T. C. 858 (1991)

The bank deposits method can be used to reconstruct income and prove fraud when taxpayers fail to maintain adequate records and underreport income.

Summary

Joseph and Mary DiLeo, along with Walter and Michele Mycek, owned and operated Arcelo Reproduction Co. , a printing business. They established secret bank accounts to divert corporate funds, which they then withdrew as personal income without reporting it on their tax returns. The IRS used the bank deposits method to reconstruct their income and assess deficiencies. The Tax Court upheld the IRS's findings, determining that the taxpayers had fraudulently underreported their income and were liable for fraud penalties. The court also ruled that the statute of limitations did not bar the assessment due to the fraudulent nature of the returns.

Facts

Joseph DiLeo and Walter Mycek each owned 50% of Arcelo Reproduction Co. , Inc. , and served as its officers. They opened several secret bank accounts and diverted a portion of Arcelo's gross receipts into these accounts from 1978 to 1982. DiLeo and Mycek withdrew funds from these accounts for personal use but did not report these withdrawals as income on their tax returns. Arcelo's corporate tax returns also omitted the diverted gross receipts. Both DiLeo and Mycek were convicted of conspiring to impede the IRS and filing false tax returns, resulting in their imprisonment.

Procedural History

The IRS issued notices of deficiency to the DiLeos, Myceks, and Arcelo for the tax years 1978 through 1982, asserting underreported income and fraud penalties. The taxpayers petitioned the U. S. Tax Court to challenge the deficiencies. The Tax Court consolidated the cases and heard them together. The court's decision affirmed the IRS's determinations, ruling in favor of the Commissioner on all counts.

Issue(s)

1. Whether the taxpayers understated their income for the years in issue as determined by the Commissioner.
2. Whether the taxpayers are liable for fraud penalties under I. R. C. sec. 6653(b) for the years in issue.
3. Whether Arcelo is liable for an addition to tax under I. R. C. sec. 6661 for 1982.
4. Whether the statute of limitations bars the assessment of the deficiencies.
5. Whether Michele Mycek and Mary DiLeo are entitled to relief as innocent spouses under I. R. C. sec. 6013(e).
6. Whether the IRS's use of a special agent from a related grand jury investigation violated Fed. R. Crim. P. 6(e) or gave the IRS an unfair discovery advantage.

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Holding

1. Yes, because the taxpayers failed to report income diverted from Arcelo's secret bank accounts, as established by the bank deposits method.
2. Yes, because the taxpayers' underreporting was intentional and part of a scheme to evade taxes, as evidenced by their criminal convictions and the use of secret accounts.
3. Yes, because Arcelo substantially understated its income tax for 1982, triggering the penalty under I. R. C. sec. 6661.
4. No, because the fraudulent nature of the returns allowed for an unlimited assessment period under I. R. C. sec. 6501(c)(1).
5. No, because Michele Mycek and Mary DiLeo did not testify, and the evidence did not support their claims of being unaware of the understatements.
6. No, because the special agent did not disclose grand jury information, and the IRS did not gain an unfair discovery advantage.

Court's Reasoning

The court applied the bank deposits method to reconstruct the taxpayers' income, relying on I. R. C. sec. 61(a), which defines gross income as all income from whatever source derived. The taxpayers' failure to maintain adequate records justified this method. The court found clear and convincing evidence of fraud due to the taxpayers' consistent underreporting, use of secret accounts, and criminal convictions for tax evasion. The court rejected the taxpayers' challenges to the bank deposits method and their claims about the statute of limitations and innocent spouse relief. Regarding the special agent's involvement, the court found no violation of Fed. R. Crim. P. 6(e) or unfair discovery advantage.

Practical Implications

This case underscores the IRS's ability to use the bank deposits method to reconstruct income when taxpayers fail to maintain proper records, especially in cases of suspected fraud. It emphasizes the importance of maintaining accurate books and records to avoid such reconstructions. The decision also highlights the severe consequences of tax fraud, including criminal penalties and civil fraud additions to tax. For practitioners, it serves as a reminder to advise clients on the importance of transparency and accurate reporting, as well as the potential use of indirect methods by the IRS to prove income. Subsequent cases have cited DiLeo in upholding the use of the bank deposits method and in affirming the broad scope of the fraud penalty.

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