THE NET WORTH METHOD

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The Net Worth Method has been around for almost a century, and is often employed by government prosecutors in criminal tax cases. This technique can be an effective tool in the forensic accountant's arsenal. However, to withstand the defenses presented by the target, the forensic accountant must be meticulous with the procedures and assumptions employed.

The Net Worth Method looks at the difference between a person's net worth (total assets[1] less total liabilities) on any two given dates. If the evidence collected can establish that a person's net worth increased more than the receipts received by a person in the form of money or property, less expenses, then this excess would be additional taxable income to that person. Also considered is the spending for living expenses, taxes, etc.

The Net Worth Method has been endorsed by the U.S. Supreme Court[2] and every circuit court. Its use is not limited to matters of tax fraud. Forensic accountants can also apply this technique to a wide array of cases, such as **divorce litigations, shareholder/partnership disputes and fraud investigations.** The Net Worth Method is considered an indirect method of proof that, if applied properly, presents compelling circumstantial evidence of a target's hiding of unreported income.

The Supreme Court has established three requirements that the government must meet before using the Net Worth Method[3]. The forensic accountant should satisfy these requirements before putting forth the Net Worth Method in a litigation scenario. These requirements are:

1. Establishing a definite opening net worth.
2. Negate plausible explanations by the defendant inconsistent with guilt.
3. Establish that net worth increases are attributable to unreported taxable income.

The Net Worth Method can be demonstrated in the following example, using amounts obtained through discovery and the forensic accountant's diligent investigation:

<u>Beginning Net Worth</u>

Cash in Banks	$ 20,000
Marketable Securities, at cost	70,000
Residence, at cost	400,000
Mortgage on Residence	(190,000)
Beginning Net Worth	$300,000

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[1] Assets are measured by their cost and not any unrealized increases in market value.
[2] See Holland v. United States, 348 U.S. 121 (1954); Friedberg v. United States, 348 U.S. 142 (1954); United States v. Calderon, 348 U.S. 160 (1954); Massei v. United States, 355 U.S. 595 (1958); Smith v. United States, 348 U.S. 147 (1954).
[3] See Holland v. United States, 348 U.S. 121 (1954).

Ending Net Worth

Cash in Banks	$ 60,000
Marketable Securities, at cost	120,000
Residence, at cost	400,000
Mortgage on Residence	(180,000)
Ending Net Worth	$400,000

Income From Known Sources

Salary	$120,000
Gift from Mother	10,000
Total Income from Known Sources	$130,000

Living Expenses and Other Expenditures	$82,000

Applying the above amounts to a commonly used Net Worth Method formula yields the following:

Ending net worth	$400,000		
Less: Beginning net worth	(300,000)		
Increase in net worth		$100,000	
Add: Living expenses and other expenditures		82,000	
Total expenditures		$182,000	
Less: Income from known sources		(130,000)	
Expenditures in excess of known sources of funds			$52,000

Analyzing the information above, the target's increase in net worth of $100,000 (from $300,000 to $400,000) is $52,000 in excess of his income from known sources.

Some important considerations when preparing a Net Worth Method analysis:

- The time period selected does not have to be a calendar year. Longer or shorter time periods can be employed as the assignment dictates.
- When computing the beginning and ending net worth, always remember to value assets at cost, not fair market or depreciated value.
- Give as much attention to the beginning net worth as you give ending net worth. Getting the target to stipulate as to these assets can avoid a "hoarding" defense at trial. The hoarding defense is when the target claims that he had significant amounts of cash at the beginning of the period of investigation that was not included in the computation.
- Estimating income and expenses is acceptable.
- After completing the Net Worth Method calculation, an attempt should be made to interview the target to negate any defenses that may be used at a later date. Again, getting the target to stipulate to certain facts, such as gifts or loans given/received during the year, can limit the opportunity for these issues to surface at trial.

The most common defenses to the Net Worth Method are:

- The calculation included assets recorded at fair market value, and not the cost. This could account for a larger increase in the ending net worth that is not attributable to unreported income.

- The target claims that the calculation did not take into account large sums of monies held outside traditional financial institutions (hoarding defense).

- Lack of thoroughness by the forensic accountant during the investigation (ie: forgetting to include gifts received in the income portion of the computation).

The Net Worth Method can be an effective tool in the forensic accountant's arsenal. ■
