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Internal Revenue Manual Section 4.10.4.6.7 (06-01-2004)
Net Worth Method

1. The Net Worth Method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income. This method requires a complete reconstruction of the taxpayer's financial history, since the government must account for all assets, liabilities, nondeductible expenditures, and nontaxable sources of funds during the relevant period.

2. The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities.

3. The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting that portion of the income which is partially or wholly nontaxable.

4. The purpose of the Net Worth Method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income.