***Cesanelli v. Commissioner, 8 T.C. 776 (1947)***

When a taxpayer fails to accurately report income, the IRS can estimate income based on industry standards and credible witness testimony, and may impose fraud penalties if there's evidence of intentional tax evasion.

**Summary**

This case involves several waiters at Solari's Grill in San Francisco who were found to have underreported their tip income. The Commissioner determined deficiencies based on a 10% of gross sales estimate, arguing it represented the average tip rate. The Tax Court upheld the Commissioner's determination, finding the waiters' testimony about receiving only 5% in tips not credible. Furthermore, the court imposed fraud penalties on the waiters for filing false and fraudulent returns, finding that their intent to evade taxes was evident in their underreporting and lack of credible explanation.

**Facts**

Several waiters were employed at Solari's Grill and received wages plus tips. The waiters filed federal income tax returns, but the Commissioner believed they underreported their tip income. The Commissioner calculated tip income based on 10% of the gross receipts from patrons served by each waiter, deducting amounts paid to busboys. The waiters claimed the average tip was only 5% of sales and blamed the underreporting on advice from unidentified employees at the Collector's office.

**Procedural History**

The Commissioner determined deficiencies and penalties against the waiters for underreporting income and, in some instances, failing to file returns. The waiters petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court consolidated the cases and reviewed the Commissioner's determinations and the evidence presented by both sides.

**Issue(s)**

1. Whether the Commissioner erred in determining that the waiters received 10% of sales as tips.
2. Whether the Commissioner erred in determining penalties of 25% for failure to file returns and 50% for fraud.

**Holding**

1. Yes, the evidence presented by the IRS was more credible than the taxpayers.
2. No, the Tax Court held that the waiters filed false and fraudulent returns with the intent to evade tax, thus, the penalties were appropriately applied.

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## Court’s Reasoning

The court found the waiters’ testimony that they only received 5% in tips to be self-serving and not credible. The court gave greater weight to the testimony of government witnesses, other waiters at Solari’s, who testified that 10% of sales was a fair estimate of tips received. The court emphasized that the government witnesses had no self-interest in the outcome of the case. Regarding the fraud penalties, the court noted that the waiters understood that tips constituted taxable income, as evidenced by their reporting of nominal amounts. The court rejected the waiters’ claims that they relied on advice from unidentified employees at the Collector’s office. The court concluded that the waiters filed false and fraudulent returns with the intent to evade tax, justifying the imposition of fraud penalties.

## Practical Implications

This case highlights the importance of accurately reporting income, even when it comes from tips. It establishes that the IRS can use industry standards and credible witness testimony to estimate income when taxpayers fail to keep adequate records. Furthermore, it underscores that the IRS can impose fraud penalties when there is evidence of intentional tax evasion, such as underreporting income and providing false explanations. Later cases cite Cesanelli for the proposition that a taxpayer’s self-serving testimony, when contradicted by more credible evidence, will not be accepted by the court. It reinforces the IRS’s authority to reconstruct income when a taxpayer’s records are inadequate or unreliable. Tax professionals use this case to counsel clients on the importance of maintaining accurate records and reporting all sources of income, no matter how small.

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