9 T.C. 1206 (1947)

Taxpayers bear the burden of proving that the Commissioner of Internal Revenue's assessment of income is incorrect, especially when dealing with income derived from illegal activities and claimed gambling losses.

Summary

Robert Carnahan contested the Commissioner's determination of tax deficiencies and fraud penalties, arguing that the Commissioner improperly calculated unreported income from illegal gambling and liquor operations and disallowed gambling losses. The Tax Court upheld the Commissioner's method for determining unreported income, finding that Carnahan failed to prove the assessment was erroneous. Furthermore, the court determined that Carnahan's claimed gambling losses could not be offset against income from illegal operations because he failed to establish what portion of his income was attributable to legitimate "bank roll" activities versus payments for "protection" from law enforcement. Fraud penalties were also upheld due to Carnahan's consistent underreporting of income and unsubstantiated claims of gambling losses.

Facts

Carnahan derived income from illegal slot machines, night clubs selling liquor, and gambling businesses in Sedgwick County, Kansas. He and his associate, Max Cohen, received payments from owners and operators of these establishments, ostensibly for providing a "bank roll" for gambling operations. Critically, Carnahan and Cohen also provided "protection" from law enforcement raids in exchange for a percentage of the businesses' profits. Carnahan kept inadequate records of his income and expenditures. The Commissioner determined that Carnahan had significantly underreported his income from 1937 to 1944 and disallowed claimed gambling losses.

Procedural History

The Commissioner assessed deficiencies in income tax and penalties against Carnahan for the years 1937-1944. Carnahan challenged these assessments in the Tax Court. The Tax Court consolidated Carnahan's case with that of Max Cohen, his associate, and considered records from related cases. Carnahan had previously pleaded nolo contendere to charges of income tax evasion for 1941 and 1942 in district court.

Issue(s)

1. Whether the Commissioner erred in determining that Carnahan received additional taxable income from illegal slot machines and gambling businesses that he failed to report.
2. Whether the Commissioner erred in disallowing Carnahan's claimed gambling

© 2025 SCOTUSreports.com. All rights reserved.

losses for the years 1937-1944.
3. Whether the Commissioner erred in determining that the income tax deficiencies were due to fraud.

Holding

1. No, because Carnahan failed to prove that the Commissioner's determination of unreported income was erroneous. The Commissioner's method of calculating unreported income based on a comparison with Cohen's expenditures was reasonable given Carnahan's inadequate record-keeping.
2. No, because Carnahan failed to adequately substantiate his gambling losses or to prove that his income from illegal activities was solely derived from legitimate partnership operations (i.e., the "bank roll") rather than from payments for protection.
3. No, because the evidence demonstrated a consistent pattern of underreporting income and claiming unsubstantiated deductions, indicating an intent to evade tax.

Court's Reasoning

The court emphasized that Carnahan had the burden of proving the Commissioner's determinations were incorrect, a burden he failed to meet. The court approved the Commissioner's method of determining unreported income, drawing parallels to the method used in Cohen's case. The court found that Carnahan's failure to keep adequate records justified the Commissioner's reliance on indirect methods of income reconstruction.

Regarding gambling losses, the court questioned the credibility of Carnahan's testimony and found that he failed to adequately substantiate the losses. More importantly, the court found that Carnahan's income from illegal activities was at least partially derived from payments for "protection," an activity distinct from legitimate gambling partnerships. Because Carnahan failed to segregate the income attributable to the "bank roll" versus protection, he could not offset individual gambling losses against the entirety of his income from these ventures. The court noted Carnahan's plea of nolo contendere in district court as further evidence of his intent to evade taxes.

The court stated, "On the record, we are convinced not only of the fact that the Commissioner's contention was not disproved, but further as to the affirmative of the issue, i. e., that the record fully supports the Commissioner's contention that a large part of the payments received by the petitioner was for protection."

Practical Implications

This case reinforces the importance of maintaining accurate and complete records, especially when dealing with income from potentially questionable sources. It highlights the Commissioner's ability to use indirect methods to reconstruct income

© 2025 SCOTUSreports.com. All rights reserved.

when a taxpayer's records are inadequate. Furthermore, it demonstrates the difficulty of claiming deductions related to illegal activities, particularly when those activities involve multiple intertwined considerations (e.g., legitimate investment versus protection payments). The case also illustrates how a prior plea of nolo contendere in a criminal tax case can be used as evidence of fraud in a subsequent civil tax proceeding. Later cases have cited Carnahan for the principle that taxpayers bear the burden of proving the Commissioner's assessment is incorrect, especially concerning unreported income.

© 2025 SCOTUSreports.com. All rights reserved.