Gleis v. Commissioner, 24 T.C. 941 (1955)

The Tax Court upheld the Commissioner's use of the net worth method to determine income tax deficiencies when taxpayer's books were deemed insufficient and found fraud for one year based on a guilty plea in a related criminal case and other evidence.

Summary

Harry Gleis was assessed tax deficiencies and fraud penalties by the Commissioner, who used the net worth method to compute income. Gleis challenged the use of this method, arguing his books were adequate. The Tax Court upheld the Commissioner's use of the net worth method, finding Gleis's books insufficient due to omissions and the cash-based nature of his businesses. The court adjusted the net worth calculation for exempt military income and cash on hand. It disallowed amortization of leasehold improvements, farm expense deductions, but found fraud only for 1947, primarily based on Gleis's guilty plea to tax evasion for that year. The finding of fraud for 1947 lifted the statute of limitations for that year, but not for other earlier years unless omissions exceeded 25% of reported income.

Facts

Harry Gleis operated several cash-based businesses, including pinball machines, jukeboxes, and a bowling alley. His bookkeeping was initially single-entry, later double-entry, managed by his wife Ann. A bank account for one business (Novelty) was opened only in 1947. Gleis purchased a farm in 1943 for cash and Stacey's Bowling Alleys in 1946, making substantial improvements. He also had interests in a tap room and a garage. The IRS used the net worth method to determine income deficiencies for 1943, 1945-1950, alleging inadequate records and fraud. Gleis pleaded guilty to tax evasion for 1947 in criminal court.

Procedural History

The Commissioner of Internal Revenue determined deficiencies and fraud penalties for Harry and Ann Gleis for tax years 1943, 1945-1950. The Gleises petitioned the Tax Court contesting these determinations. Prior to the Tax Court case, Harry Gleis was indicted in federal court for tax evasion for 1946-1950, pleading guilty to the 1947 count. The Tax Court heard the case regarding the tax deficiencies and fraud penalties.

Issue(s)

1. Whether the Commissioner was justified in using the net worth method to determine the petitioners' income.
2. Whether the petitioners could amortize the cost of leasehold improvements instead of depreciating them.
3. Whether certain farm expenses (bulldozing and lake construction) were

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deductible.
4. Whether any part of the deficiency for each year was due to fraud with intent to evade tax.
5. Whether the statute of limitations barred assessment and collection for tax years 1943, and 1945 to 1947.

Holding

1. Yes, because the net worth method is permissible when the taxpayer's books do not clearly reflect income, especially in cash-based businesses, and inconsistencies existed between reported income and net worth increases.
2. No, because the lease agreement for the bowling alley was considered a conditional sale, giving Gleis the option to extend the improvements' use beyond the lease term, thus depreciation over the useful life was appropriate, not amortization over the lease term.
3. No, because expenditures for clearing land and constructing a lake are capital improvements, not deductible farm expenses.
4. Yes, for 1947, because Gleis pleaded guilty to tax evasion for that year, and other evidence supported fraudulent intent; No, for other years, because the evidence of fraud was not clear and convincing.
5. Yes, for years preceding 1947, unless recomputation for 1946 showed omitted income exceeding 25% of reported income, because the statute of limitations generally applies unless fraud is proven.

Court's Reasoning

The court reasoned that **(1) Net Worth Method Justified:** Section 41 of the 1939 Internal Revenue Code allows the Commissioner to compute income using a method that clearly reflects income if the taxpayer's method does not. The net worth method is not a method of accounting but evidence of income. Inconsistencies between Gleis's books and net worth increases justified its use. The court adjusted the Commissioner's net worth calculation to account for exempt military pay and estimated cash on hand, applying the *Cohan* rule for reasonable estimation where exact figures were unavailable. **(2) Leasehold Improvements:** The lease was deemed a conditional sale, giving Gleis control over the improvements' lifespan. Depreciation over the useful life is proper when the lessee can extend the asset's use. **(3) Farm Expenses:** Clearing land and building a lake are capital expenditures that enhance the farm's value and are not currently deductible farm expenses. **(4) Fraud:** Fraud requires a deliberate intent to evade tax, proven by clear and convincing evidence. For 1947, Gleis's guilty plea to tax evasion was strong evidence of fraud. While other discrepancies existed, fraud was not clearly proven for other years. The court quoted *E. S. Iley*, stating, "Fraud implies bad faith, a deliberate and calculated intention on the part of the taxpayer at the time the returns in question were filed fraudulently to evade the tax due." **(5) Statute of Limitations:** Fraud removes the statute of limitations. Since fraud was found for 1947, the statute did not bar assessment for that year. For other years, the standard

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statute of limitations applied unless income omissions were substantial (over 25%).

Practical Implications

Gleis v. Commissioner reinforces the IRS's authority to use the net worth method when taxpayer records are inadequate, particularly in cash-intensive businesses. It highlights that taxpayers bear the burden of maintaining adequate records. The case demonstrates that a guilty plea in a criminal tax evasion case is strong evidence of fraud in civil tax proceedings. It clarifies that leasehold improvements are depreciable over their useful life, not necessarily amortizable over the lease term, if the lessee effectively controls the asset's lifespan. Practitioners should advise clients in cash businesses to maintain meticulous records and be aware that inconsistencies between lifestyle and reported income can trigger a net worth investigation. The case also underscores the significant consequences of a fraud determination, including the removal of the statute of limitations and imposition of penalties.

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