Polsen v. Commissioner, 25 T.C. 337 (1955)

The net worth method of income computation is permissible even if a taxpayer maintains books, and consistent understatement of income coupled with other indicia can establish tax fraud.

Summary

The Tax Court upheld the Commissioner’s deficiency determination and fraud penalties against petitioners who understated their income. The Commissioner used the net worth method to reconstruct income, which petitioners challenged, primarily disputing the initial cash on hand. The court found petitioners had a larger cash hoard than the IRS initially allowed but still less than claimed by petitioners. Crucially, the court found consistent underreporting of income, coupled with other factors like inadequate record-keeping after warnings, inconsistent statements, and a criminal conviction for tax fraud, sufficient to prove fraud. This case illustrates the application of the net worth method and the evidentiary standards for proving tax fraud.

Facts

Petitioners, Abraham and Molly Polsen, were determined by the Commissioner to have deficiencies in income tax and to be liable for fraud penalties for the years 1945 through 1949.

The Commissioner used the net worth method to compute the petitioners’ income.

Petitioners stipulated to the correctness of all items in the net worth statement except for the amount of cash on hand at the beginning of the period.

Petitioners claimed to have approximately $42,000 in cash on hand at the start, while the Commissioner determined they had only $1,000.

Molly Polsen was convicted of felony for fraudulent understatements of income for four of the five years in question.

Petitioners’ records were deemed inadequate, even after warnings from a revenue agent and their accountant.

Procedural History

The Commissioner determined deficiencies and fraud penalties against the Polsens.

The Polsens petitioned the Tax Court to redetermine the deficiencies.

The Tax Court heard the case and issued an opinion.

Issue(s)

1. Whether the Commissioner was justified in using the net worth method to compute petitioners' income despite petitioners maintaining books and records.

2. Whether the Commissioner proved that any part of the deficiencies was due to fraud with intent to evade tax.

Holding

1. Yes, because the net worth method is permissible even if a taxpayer maintains books, especially when those books do not accurately reflect income.

2. Yes, because the consistent understatement of income, coupled with other indicia of fraud such as inadequate records after warnings, inconsistent statements, and a criminal conviction for tax fraud, sufficiently demonstrated fraudulent intent.

Court's Reasoning

The court stated that the net worth method is a valid way to evidence income, even when taxpayers maintain books. Quoting *Harry Gleis, 24 T.C. 941, 949*, the court noted, "Nor is its use banned simply because a taxpayer maintains a set of books from which an income can be computed."

