***28 T.C. 658 (1957)***

The IRS can use the net worth method to determine a taxpayer's income if the taxpayer's records are inadequate and do not clearly reflect income.

**Summary**

The Commissioner of Internal Revenue (IRS) determined deficiencies in David Courtney's income tax for multiple years, using the net worth method due to the inadequacy of Courtney's records. Courtney, a grocer and farmer with limited accounting knowledge, argued his records were sufficient, and the IRS should not have used the net worth method. The Tax Court upheld the IRS's use of the net worth method, finding Courtney's records did not clearly reflect his income. The court also addressed the statute of limitations, concluding that the five-year period applied for one year due to a substantial omission of gross income. Additionally, the court ruled on additions to tax for negligence and failure to file declarations of estimated tax, upholding some of the IRS's assessments.

**Facts**

David Courtney operated a grocery store and a farm. He and his wife, with limited accounting knowledge, kept basic records of sales, purchases, and expenses. An attorney prepared Courtney's tax returns based on the information provided, without conducting a formal audit of the records. The IRS determined deficiencies in Courtney's income tax for 1949, 1950, 1951, and 1953, using the net worth method because his records were deemed inadequate. The net worth method showed substantial unreported income. Courtney disputed the use of this method and argued the statute of limitations barred assessments for 1949 and 1950. The IRS also sought additions to the tax for negligence and failure to file estimated tax declarations.

**Procedural History**

The IRS determined income tax deficiencies and additions to the tax against Courtney. Courtney contested these determinations in the U.S. Tax Court. The Tax Court considered the adequacy of Courtney's records, the applicability of the statute of limitations, and the correctness of the additions to tax.

**Issue(s)**

1. Whether the IRS properly used the net worth method to determine Courtney's income.

2. Whether the statute of limitations barred the assessment of deficiencies for 1949 and 1950.

3. Whether additions to the tax for negligence and failure to file estimated tax

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declarations were proper.

**Holding**

1. Yes, because Courtney's records were inadequate and did not clearly reflect his income.

2. Yes, for 1949 because the taxpayer omitted gross income exceeding 25% of that stated on his return, invoking the five-year statute of limitations; No, for 1950, because the Commissioner failed to demonstrate an omission of gross income in excess of 25% of that reported on the return.

3. Yes, for negligence, the court upheld an addition to tax for negligence for 1953; yes, for failure to file estimated tax. The court upheld additions for failure to file declarations of estimated tax.

**Court's Reasoning**

The court examined whether Courtney's records clearly reflected his income, as required by Internal Revenue Code § 41. The court noted the taxpayers' limited accounting skills, the lack of an audit, and conflicting testimony about the accounting methods used. The court found the records were not sufficient and did not clearly reflect income, supporting the IRS's use of the net worth method. The court cited *Morris Lipsitz, 21 T.C. 917, 931 (1954)*. The court reasoned that the deficiencies determined by the net worth method were substantially in excess of those reported, highlighting the unreliability of the taxpayer's records.

Regarding the statute of limitations, the court applied Internal Revenue Code § 275(c), which allows for a five-year statute of limitations if the taxpayer omits from gross income an amount exceeding 25% of the gross income stated on the return. The court examined the unreported income relative to the gross income stated in the returns and found that for 1949, the unreported income, when reduced by deductions claimed on the return, exceeded the 25% threshold, triggering the extended statute of limitations. The court held that the 5-year statute of limitations applied because the unreported income was attributable to an omission of gross income. However, for 1950, the court held the commissioner did not prove the deficiency resulted from omission of gross income. The court distinguished its ruling from *H. Leslie Leas, 23 T.C. 1058 (1955)*.

For the additions to tax, the court noted that a 5% negligence penalty was asserted. Based on the facts, the court upheld the addition for negligence, as deficiency was

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