

Larry's Tax Law

Failure to Retain Adequate Business Records Will Lead to Disastrous Results

By Larry Brant on 2.12.14 | Posted in Tax Procedure

On January 27, 2014, Judge Haines of the United States Tax Court issued a decision in ***Ydney Jay Hall v. Commissioner***, TC Memo 2014-6. This case illustrates that a taxpayer's failure to retain adequate business records to substantiate income and expenses will lead to disastrous results.

The taxpayer, Ydney Jay Hall, is a practicing attorney admitted to practice before the United States Tax Court. His law practice income was reported on Schedule C of his Individual Income Tax Return. Upon examination of Mr. Hall's 2008 return, the Service asked to review his books and records relating to the law practice. The Service, believing Mr. Hall did not fully respond to its request for information, summoned bank records. With that information, it reconstructed his business income for the tax year. The results of the audit reconstruction were not pretty.

The IRS issued a deficiency notice to the taxpayer, asserting he had underreported his income by \$76,681 for the tax year. In addition, the Service disallowed deductions for travel and other expenses listed on Schedule C totaling \$63,542 as the taxpayer did not maintain any books or records for his business activities and failed to provide proof he actually paid the expenses (e. g., receipts, invoices, cancelled checks or other evidence of payment). To put salt on the wound, the Service assessed an accuracy related penalty against the taxpayer.

Mr. Hall filed a petition in the United States Tax Court challenging the notice of deficiency and the assessment of taxes and penalty. He represented himself in the case.

Unreported Income

In the Ninth Circuit, the Service is required to show minimal evidence supporting its conclusion a taxpayer underreported income. Then, the burden shifts to the taxpayer who must prove by a preponderance of the evidence that the Service's determination is incorrect.

In this case, the Service in its brief conceded the correct amount of underreported income was \$61,014 (rather than \$76,781). It based this amount on a reconstruction of the taxpayer's bank deposits. In response to the taxpayer's challenge to the government using this method to recreate his income, the court said: "If a taxpayer has not maintained business records or the taxpayer's business records are not adequate, the Commissioner is authorized to reconstruct the taxpayer's income by any method that, in the Commissioner's opinion, clearly reflects that

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taxpayer's income. The Commissioner's reconstruction need not be exact, but it must be reasonable in the light of all the surrounding facts and circumstances (*citations omitted*).

The taxpayer provided no documentation or other evidence supporting the income reported on his Schedule C other than his testimony which the court classified as "self-serving and uncorroborated." Consequently, the court found for the government and concluded Mr. Hall failed to report income of \$61,014 in 2008.

Disallowed Deductions

Unfortunately for the taxpayer, the case did not get any better when the court turned its attention to the disallowed business deductions. The court stated: "Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving he is entitled to the deductions claimed." In accordance with IRC Section 162, "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The court then went on to reiterate the well established rule of law that taxpayers, however, are required to maintain records to support these deductions and to enable the Service to determine the correct tax liability.

In the instant case, the taxpayer did not maintain any books or records of his business activities. He also failed to produce any receipts, invoices, bills, cancelled checks or other documents to support payment of the business expenses reported on the tax return.

In accordance with IRC Section 274(d), no deduction is allowed for travel, entertainment or gifts unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement as to: **(1)** the amount of the expense; **(2)** the time and place of the travel or entertainment, or the date and description of the gift; **(3)** the business purpose of the expense; and **(4)** in the case of entertainment or gifts, the business relationship between the taxpayer and the persons entertained.

If a taxpayer establishes he paid or incurred an otherwise deductible expense other than travel, entertainment, or gift expenses ("non-274(d) expenses"), but does not establish the amount of the expense, the Court has authority to estimate the amount of the expense but it can weigh heavily against the taxpayer. In order to estimate the amount of the expense, the court, however, must be presented with some reasonable basis upon which an estimate may be made.

In the instant case, the taxpayer failed to offer any evidence to support any of the expenses in question other than his own uncorroborated testimony. The court reiterated that it is not required to accept such testimony. Consequently, it concluded that the taxpayer failed to meet his burden to substantiate the business expenses in question. The court upheld the Service's disallowance of the business expenses.

Penalty Assessment

Last, the court looked at the 20% accuracy related penalty imposed under IRC Section 6662 for the taxpayer's negligence or disregard of rules or regulations. Failure to maintain adequate books and records or provide substantiation of items reported on a tax return constitutes negligence. IRC Section 6662(c); T. Reg. Section 1.6662-3(b)(1). A taxpayer may obtain reprieve from the imposition of the penalty if he establishes he acted with reasonable cause and in good faith.

In this case, the taxpayer failed to address his liability for the penalty assessment other than including a brief statement in his brief that he was not liable for an accuracy related penalty. Despite his failure to present any additional argument to support an abatement of the penalty, the court looked to see if any evidence in the record supported that the taxpayer acted in good faith and with reasonable cause. Finding no such evidence, the court upheld the penalty assessment.

Conclusion

This case leaves us with a few obvious take-aways. First, taxpayers must maintain adequate records. Failure to do so could lead to a finding by the Service that the taxpayer misreported income and expenses. Second, as Mr. Hall encountered firsthand, it will likely lead to the imposition of an accuracy related penalty. Last, for tax return preparers, it could lead in egregious situations to the imposition of a tax preparer penalty under IRC Section 6694(b)(2).

Caution is advised.

Tags: Individual Income Tax Return, Tax Audit, Tax Examination, Underreported Income