

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XII - A Reoccurring Theme: Don't You Know That Keeping Adequate Business Records Is Required?

10.15.24 01.07.26

In this Part XII of my multi-part series on some of the not-so-obvious aspects of S corporations, I explore a consistent theme - taxpayers lose fights with taxing authorities when they fail to maintain adequate records. Keeping adequate records is vitally important to S corporations and their shareholders or, for that matter, all taxpayers.

Background

Time and time again, taxpayers lose their battles with the IRS and other taxing authorities for the same reason - failure to maintain adequate records. One of the greatest services that tax advisers can provide their clients is preaching the virtues of maintaining good records.

Moore v. Commissioner

On April 30, 2024, the 7th Circuit Court of Appeals, in *Moore v. Commissioner*, 133 AFTR 2d 2024-1457, affirmed the decision of the U.S. Tax Court. The case illustrates why good recordkeeping is required.

The case involved Nevco, an S corporation solely owned by Gayle Moore. Ms. Moore is married to Scott Moore. They file their individual income tax returns jointly. Gayle is the CEO of Nevco. Scott is the VP of Strategic Initiatives of Nevco. The corporation is engaged in manufacturing scoreboards, video displays and other equipment used at indoor and outdoor athletic events.

Nevco found itself falling behind its competitors in terms of product development. Accordingly, it hired Mr. Robert (initially as a consultant but eventually as an employee, serving as President and COO) to focus on product development. He reported to Ms. Moore.

For tax years 2014 and 2015, the S corporation claimed a tax credit under Code Section 41 that related to research to improve its products. The credits flowed through to the sole shareholder, Ms. Moore, and were reflected on the couple's joint income tax returns.

Upon audit, the IRS took issue with the amount of the credits. A focus of the examination was lack of recordkeeping.

As background, we must understand Treasury Regulation Section 1.41-4(a). It provides in part:

"Research activities related to the development or improvement of a business component constitute qualified research only if the research activities meet [certain] ... requirements ..."

One of those requirements is contained in Treasury Regulation Section 1.41-4(d), which provides that:

"A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."

In this case, in computing the credits, Nevco included all of Robert's salary and bonus for the years at issue, asserting that he, as the corporation's President and COO, oversaw all research and development activities. Unfortunately, the taxpayers presented the IRS with no documents or other evidence to support that claim. Accordingly, the auditor denied the credits to the extent they were based on Robert's compensation.

The U.S. Tax Court, upon receipt of the taxpayers' petition, was given the task of determining whether Nevco was correct in considering Robert's salary and bonus in the computation of the credits. In doing so, the court examined whether Robert was engaged in "qualified" research and/or was engaged in direct supervision or support of others performing "qualified" research.

Unfortunately for the Moores, no evidence was presented to the Tax Court substantiating (i) how much of Robert's time was dedicated to "qualified" research; and/or (ii) how much of Robert's time was dedicated to supervising or supporting others in conducting "qualified" research. Ultimately, based on the lack of evidence, the court ruled in favor of the government.

Rather than take their licks and go home, the Moores appealed to the Seventh Circuit Court of Appeals. Judge Easterbrook wrote the court's opinion. It is brief. The court affirmed the U.S. Tax Court, pointing out:

- I. Despite the documentation requirements set forth in Treasury Regulation 1.41-4(d), the corporation maintained no written record of how Robert spent his time. Further, at trial, Robert could not estimate how much time he devoted to "qualified" research, and no evidence was presented to prove that he supervised or supported others involved in "qualified" research. The Moores bore the "burdens of

production and persuasion" and because they failed to carry that burden, the court concluded that the Tax Court's conclusion was dispositive.

2. The court acknowledged that proper computation of the credits is a matter of mathematics. But, as it eloquently pointed out, "[t]o do math, one needs accurate details."

The Moores lost the battle.

Conclusion

Moore illustrates the often overlooked or forgotten tax law rule applicable to S corporations and other taxpayers: The maintenance of adequate records is required.

Stay tuned for more blog posts in my continuing series on Subchapter S, focusing on the not so obvious and the traps that exist for the unwary.

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