SUBSTANTIATION OF BUSINESS EXPENSES

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COURSE OVERVIEW

Course Description

While practitioners and taxpayers alike frequently focus on the substantive rules regarding the deductibility of an expense, an otherwise deductible amount may be disallowed if it is not properly substantiated. Adequate substantiation is by its nature dependent upon the facts and circumstances of each case. In this course, we will review the basic rules of substantiation and look at the facts presented in several recent cases to gain insight into the level of substantiation necessary to support various types of business expenses.

Learning Objectives

After completing this course you will be able to:

- Identify the types of records necessary to support a business deduction
- Recognize the various methods of substantiation available
- Indicate when corroborating evidence is necessary to substantiate a deduction
- Define the substantiation requirements for various specific types of expenses

GENERAL APPROACH TO BUSINESS DEDUCTIONS

Introduction

Deductions are a matter of legislative grace, and taxpayers always bear the burden of proving entitlement to any deduction claimed.[1] IRS determinations are presumed to be correct; if an appeal is made to the Tax Court the court will start with this presumption and only find for the taxpayer if he or she successfully overcomes their burden of proof.[2]

Taxpayers often incorrectly believe that the IRS must prove that claimed deductions are not permissible. Nothing could be further from the truth, as George Bristol discovered when he petitioned the Tax Court with regard to the IRS's denial of his business deductions.[3] George operated Bay Area Bee Busters, a bee and wasp removal business. He did not file federal income tax returns or pay taxes relating to the years 2009 and 2010. The IRS analyzed George's bank account records to determine his gross receipts and prepared "substitute for returns" ("SFRs"). As is always the case with SFRs, the IRS did not give George the benefit of any deductions. George, nonetheless, believed that he was entitled to deduct business expenses and decided to fight for his right to do so in Tax Court. Unfortunately for George, his utter lack of substantiating proved to be his undoing, and he ended up paying tax on his income undiminished by any business expenses he may have had.

The Internal Revenue Code ("Code") provides that every taxpayer must keep such records as necessary to establish his or her entitlement to deductions.[4] Furthermore, if the taxpayer carries a deduction over to a succeeding year, he or she must keep records to substantiate that amount carried over. For example, to substantiate a capital loss carryover, the taxpayer must show: (1) that a loss was incurred; (2) when the loss was incurred; (3) that the taxpayer is entitled to deduct the loss; (4) whether the loss is capital or noncapital, or business or personal; and (5) the amount of the capital gain during the intervening years, in order to compute any allowable carryover.[5]

What Constitutes a Business Expense

Code section 162 allows a business taxpayer to deduct from its gross income its "ordinary and necessary" business expenses. To qualify for a deduction, the expense must be:

1. Paid or incurred during the taxable year;
2. Paid or incurred for carrying on a trade or business;
3. Ordinary; and
4. Necessary.

The determination of when an expense is deductible depends on the taxpayer's overall method of accounting. Cash basis taxpayers generally deduct expenses only when paid, while an accrual basis taxpayer may deduct expenses under the "all events test" when: (1) all events have occurred that determine the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred.[6] A "trade or business" is any activity regularly and continuously undertaken for a bona fide profit, other than the activities of an investor trading in securities. An employee is also considered to be in the trade or business of being an employee.

In general, an expense is "ordinary" if it is considered normal, usual, or customary in the context of the particular business out of which it arose.[7] An expense is "necessary" if it is appropriate and helpful to the operation of the taxpayer's trade or business.[8] The determination of whether an expenditure satisfies the requirements for deductibility under Code section 162 is a question of fact.[9]

Jason Abelitis could probably tell you a lot about the definition of "ordinary and necessary" now that his Tax Court case has been decided. Jason owned and operated a mobile advertising business which consisted of placing roadside signs to advertise for small businesses as well as for his own mobile advertising business.[10] He advertised for various clients, including a business that bought junk cars and a home refinancing business, and he posted lunch specials for a deli. The signage was typically in the form of paper fliers and was provided to Jason by his clients. He described the signage as being anything from a piece of poster board with a wooden stake on the back to "nicer" plastic signs with a metal stake on the back that he would manually push into the ground. Typically, however, the signage was a regular-size piece of paper.

Unfortunately, Jason had fewer than two dozen clients, and most of the signage that he posted was to advertise for his own mobile advertising business. These postings were typically a standard letter sheet posted onto other signs, lamp posts, or telephone poles promoting petitioner's mobile advertising business. Although he drove all over the United States, he admitted that most of his clients were local and that he had only one "nationwide" client, a refinancing website.

Jason attached a Schedule C to his 2010 tax return reporting gross receipts of $7,200 and $64,775 in car and truck expenses using the standard mileage rate. He claimed that he drove a total of 129,550 miles, from his mobile advertising business, driving almost every day for this purpose. When he was audited, Jason attempted to document his claimed mileage by creating travel logs and a monthly schedule of locations to which he had driven. These documents indicated that Jason had traveled to over 30 states, despite that the modest amount of business income he generated came almost exclusively from local businesses. The IRS disallowed the mileage expenses and Jason appealed to the Tax Court.

The court denied Jason's deductions because it found that, under the circumstances, Jason's extensive automobile travel was not "ordinary and necessary." Furthermore, the court was unpersuaded that the expenses were adequately substantiated. The court wanted to see receipts or invoices provided to clients to support his claimed travel, but Jason never provided his clients with either of these. The fact that Jason did not maintain a contemporaneous mileage log greatly influenced the court. Given that the documentation was created after the fact, the court held that his non-contemporaneous travel logs and monthly schedule were insufficient to meet the substantiation requirement.

A further problem for Jason was that his claimed business travel was not plausible. The court did not believe Jason's assertion that he was able to drive almost 10 hours per day for his regular job with a telephone service provider and also 129,550 miles per year for his mobile advertising business. Although Jason stated that he was able to do this because he loved to drive and he slept very little because of insomnia, the court was not swayed by this argument. As a result, the court held that Jason did not satisfy the strict substantiation requirements of Code section 274(d) for claiming car and truck expenses.

SUBSTANTIATING DEDUCTIONS

In General

Every year the Tax Court hears dozens of cases dealing with the substantiation of business deductions. This course includes a summary of a number of recent Tax Court cases on this issue and provides guidance to better address the challenges involved. Critical facts in these cases are highlighted to emphasize what substantiation standards must be met for the taxpayers to be able to deduct their business expenses. Most importantly, this course uses the reported cases to develop guidance regarding what types of evidence will be needed to prevail in a dispute regarding business

deductions. Even though each taxpayer's factual scenario is unique and substantiation issues are a question of fact, some common themes can be ascertained.

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, § 274(a)(1), as revised by the ***Tax Cuts and Jobs Act of 2017***, generally disallows a deduction for any item with respect to an activity that is of a type generally considered to constitute entertainment, amusement, or recreation.

Taxpayers may continue to deduct 50 percent of the cost of business meals if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered lavish or extravagant. The meals may be provided to a current or potential business customer, client, consultant or similar business contact.

Food and beverages that are provided during entertainment events will not be considered entertainment if purchased separately from the event.

Prior to 2018, a business could deduct up to 50 percent of entertainment expenses directly related to the active conduct of a trade or business or, if incurred immediately before or after a bona fide business discussion, associated with the active conduct of a trade or business.

The Code and regulations specifically require the taxpayer to maintain records sufficient to establish the three separate elements for each expense deduction: (1) the date of the expenditure; (2) the amount of the expenditure; and (3) the business purpose of the expenditure. If the deduction is related to the use of property (i.e., depreciation), the taxpayer must also document the amount of the business use of such property and the total use of the property for the tax year.

It is crucial that attention be paid to each of these separate elements. In order to meet the adequate records requirements of the Code, a taxpayer must maintain some form of records and documentary evidence that in combination are sufficient to establish ***each*** element of an expenditure or use.[11] Frequently taxpayers believe that merely maintaining a record that the expenditure was made will suffice. As attorney Richard Canatella discovered in a case discussed in more detail below, solely demonstrating that an expenditure was made will seldom suffice.[12]

Furthermore, each individual expenditure should generally be separately documented. However, if adequate records are maintained for part of a year and there is adequate evidence that the same expenditures are incurred evenly throughout the year, the representative documentation can be used to extrapolate the full amount of the deduction. This strategy, of course, should be used with caution and only when it can be clearly demonstrated that the same type and level of expenditure is incurred throughout the relevant period.

Written evidence has considerably more probative value than oral evidence alone. In addition, the probative value of written evidence is greater the closer in time it relates to the expenditure or use. A contemporaneous log is not required, but such logs have a high degree of credibility not present with respect to a statement prepared subsequent

to the event when generally there is a lack of accurate recall. When a contemporaneous record is not kept, the corroborative evidence required to support the deduction must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence.[13]

To meet the "adequate records" requirements of Code section 274(d), a taxpayer must maintain an account book, diary, log, statement of expense, trip sheets, or similar record and documentary evidence which, in combination, are sufficient to establish each element of an expenditure or business use of property. It is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record which duplicates information reflected on a receipt so long as the taxpayer-kept account book and third-party's receipt complement each other in an orderly manner.

The degree of substantiation necessary to establish a business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal, if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.

In order to constitute an adequate record, the record must contain sufficient information as to each element of every business use. However, the level of detail required in an adequate record to substantiate business use may vary depending upon the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of a truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording the total number of miles driven during the taxable year, the length of the delivery route once, and the date of each trip at or near the time of the trips. Alternatively, the taxpayer may establish the date of each trip with a receipt, record of delivery, or other documentary evidence.

If any information relating to the elements of an expenditure or use, such as place, business purpose, or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, log, statement of expense, trip sheet, or similar record, provided such information is recorded at or near the time of the expenditure or use and is elsewhere available to the district director to substantiate such element of the expenditure or use.

If a taxpayer fails to establish that he or she has substantially complied with the "adequate records" requirements with respect to an element of an expenditure or use, then the taxpayer may establish such element by providing two items: (1) his or her own statement, whether written or oral, containing specific information in detail as to such element; and (2) other corroborative evidence sufficient to establish such element. With respect to the description of the cost or

amount, time, place, or date of an expenditure or use, the corroborative evidence must be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witnesses setting forth detailed information about such element, or the documentary evidence. With respect to either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.

THE COHAN RULE EXCEPTION

Introduction

Courts have held that where a taxpayer has established that he has incurred a trade or business expense, failure to prove the exact amount of the otherwise deductible item may not always be fatal. Generally, the Court may estimate the amount of such an expense and allow the deduction to that extent.[14] This so-called "Cohan Rule" (from a case involving entertainer George M. Cohan) permits a deduction for ***estimating*** expenses other than travel-away-from-home, entertainment, gifts, listed property and local travel expenses. This rule is based on the concept that a deficiency asserted by the IRS should not be upheld if the evidence clearly shows that it is incorrect, even if the taxpayer does not establish the exact amount of tax that he or she owes. This does not mean that where IRS totally denies deductions by a taxpayer who obviously incurred some deductible expenses that the deficiency determination is void. It does mean that, upon review, the court, may take it upon itself to determine the correct deficiency by estimating the amounts actually expended.

Thus, under the right circumstances, the Tax Court may accept the taxpayer's testimony without substantiating documentary proof. In order to prevail under the Cohan Rule, the taxpayer must provide sufficient information upon which to base an estimate; simply proving that some expenses must have been incurred is not enough.

For example, Michael Stephens was a truck driver and the sole owner of the Stephens Southern Express, Inc. ("SSEI"), a subchapter S corporation. [15] In each year between 2005 and 2008, SSEI timely filed Form 1120S. In 2009, the IRS audited, these returns and disallowed many of the expenses appearing on those returns. This meant that Michael, as the sole shareholder of SSEI, had additional income with respect to those years. Although Michael testified about the expenses for which he was unable to provide documentation, the Cohan rule proved to be of no assistance to him because his testimony regarding the expenses was general and did not provide the Tax Court with evidence establishing both the fact ***and*** general amount of the business expenses necessary to allow an estimation.

Contemporaneous Documentation and Corroboration

As Jim Flake learned, conflicting records can prove just as fatal to a deduction as a lack of substantiation.[16] Jim was self-employed in the business of building and repairing radio towers throughout the United States. At times his business required that he drive long distances to these radio towers. While his wife Martha was primarily a homemaker

responsible for raising the children, she also assisted her husband in various aspects of the radio tower business, including invoicing and billing their clients.

The couple's recordkeeping method included the use of a calendar to record the total number of business miles driven to various cities and dates. Each monthly calendar sheet contained a notation of the total number of business miles driven that month. The couple also kept their receipts for business expenditures in plastic bags along with index cards that showed the amounts and types of expenses.

When the couple filed federal income tax returns for 2007 and 2008 they reported $60,316 in car and truck expenses using the standard mileage rates. The IRS disallowed the couple's expense and the Flakes took their case to Tax Court.

After examining the calendars, the court found that they showed significantly fewer total business miles than the couple claimed on their tax returns. In addition, various entries on the calendar sheets strained credibility, and the Flakes did not offer any plausible explanation for these entries. Given these evidentiary infirmities, the court did not find the calendars reliable or helpful in establishing their car and truck expenses. In the absence of adequate records to establish each element of their claimed car and truck expense deductions, and absent other sufficient corroborative evidence, the Flakes failed to satisfy the strict substantiation requirements of IRC §274.

A mileage log, of course, is easy to fabricate. For that reason, a mileage log alone may not suffice if there is no corroborating evidence, as was the case in a matter involving Richard Rasmussen and his wife.[17] Rich and his wife operated a window installation business. They claimed as a deduction car and truck expenses incurred in their business operation. However, the IRS disallowed these expenses.

When they lost in Tax Court the couple appealed to the United States Eighth Circuit Court of Appeals. Unfortunately for the Rasmussens, the Eighth Circuit sided with the IRS and the Tax Court, holding that they could not deduct car and truck expenses due to a lack of substantiation of those expenses. The courts' decisions hinged on the couple's lack of documentary evidence to corroborate their stated expenses. The couple's mileage log, documenting the trips they made in support of their business, was not enough to constitute adequate substantiation without any receipts of purchases or client invoices.

The court came to the same conclusion when reviewing Michael Houchin's 2010 tax returns. Mike was laid off in 2010.[18] He decided to make the best of the situation by collecting unemployment compensation and engaging in the business activity of picking up old newspapers and selling them to a recycling company. The former truck driver would put his skills to good use by driving his truck to whatever locations he could find that had available newspapers. He maintained a mileage log wherein he recorded the date, starting and ending odometer readings, business mileage, and personal mileage for each trip with his truck during 2009 and 2010. By the latter part of 2010, Mike had secured a job as a truck driver with UPS.

On his 2010 return, Mike reported gross income of $1,274, office expenses of $142, and car and truck expenses of $17,978, for a net loss of $16,846. Upon audit, Mike submitted his mileage logs to the IRS to substantiate his truck expenses. The IRS felt that the documentation was inadequate because the entries neither reflected a business purpose nor the places where his business activity occurred. The IRS asked that Mike provides information regarding the places where he traveled for business, whereupon he resubmitted his mileage log, this time writing in the places where he guessed he may have gone. Mike's guesses were deemed to be insufficient for the IRS and they disallowed all of the truck expenses.

The Tax Court sided with the IRS, agreeing that Mike failed to meet the substantiation requirements of Code section 274(d) for the vehicle expenses related to his recycling business. The court held that in order to meet the substantiation requirement, Mike needed to provide evidence to corroborate the information in his mileage log. While relying on memory to "fill in the holes" of substantiation may pass muster under some circumstances, the longer the period between an event and the recording of the event, the less reliable one's memory is. The fact that Mike waited literally years to record the business purpose and estimated mileage of each trip did him in. Recall that the burden of proof is on the taxpayer; uncorroborated estimates are never likely to carry the day.

Not all corroboration is created equal. In addition to the requirement that taxpayers provide supporting documentation such as receipts of invoices to verify the information contained in mileage logs, the court requires that the supporting documentation be credible. Mark Van Velzor failed to adequately appreciate this.

Mark was a mechanical engineer who sought to expand his business into Central and South America.[19] In order to facilitate the expansion, he hired a consultant from El Salvador. The cash economy prevails in El Salvador, so Mark paid the contractor entirely in cash because she would not take checks. Mark claimed to have made the cash disbursements from funds he borrowed from family and friends and cash he kept in a lockbox in his attic. Thus, there were no bank transactions corresponding to the payments. He paid the contractor in four quarterly payments documented by receipts the contractor executed. The IRS disallowed deductions based on these expenses, and Mark appealed to the Tax Court.

The Tax Court found for the IRS, holding that Mark failed to substantiate the contract labor expense deductions. The court held that Mark's self-serving testimony and contractor receipts were not enough to substantiate the expenses. The court felt that his method of making payments with only untraceable cash disbursements strained credulity, especially in light of the fact that he actually did maintain a bank account. Thus, the court found that Mark's testimony was not credible. Moreover, the court found that the provided receipts were unreliable and was not convinced that the receipts proved that the payments were actually made.

Sometimes certain deductions and their documentation will meet the substantiation requirement and others within the same return will not. Stephen Bowerman and his wife Jani lived in Alaska.[20] Stephen was self-employed and earned income from various construction jobs. Jani worked as an administrative assistant for UPS. The couple deducted their

mortgage interest, contract labor expenses, and costs of goods sold on Schedule C deduction. The Bowermans also claimed the employee business expense deduction on Schedule A, as well as their attorney's fees.

The Tax Court agreed that the couple had adequately substantiated the deductions for the contract labor and cost of goods sold for the construction business. While the Bowermans relied in part on unsworn statements from contract laborers and hiring agents, those statements were corroborated with several pay statements and check copies from other workers. The court felt that this was enough to substantiate the deductions.

However, the court denied other deductions, including mortgage interest, unreimbursed employee business expenses, and attorney's fees. Attorney's fees are generally not deductible if they are personal in nature. If such expenses are related to business or incurred in a context related to the production of income, they are deductible. The Bowermans, however, submitted no documentation to substantiate the business-connected nature of these fees.

Substantiating the Nature of an Expenditure

Not only must a taxpayer substantiate the business purpose of a claimed deduction, but sometimes the ***nature*** of the expenditure must be substantiated as well. For example, Code section 195(a) provides that generally, taxpayers are not allowed to deduct start-up expenditures; instead, they may elect to treat start-up expenditures as deferred expenses which can then be amortized over a period of not less than 60 months, beginning with the month in which the active trade or business begins. This election is not automatic but must be affirmatively made by the taxpayer. If an expenditure does not qualify for start-up amortization the costs are simply treated as capital contributions by the owners and added to the basis of their interest in the business. Code section 195(b)(1) allows for a deduction of up to $5,000 in start-up costs (limitations apply when start-up costs exceed $50,000) in the first year of the business, with any remaining start-up costs being amortized over a 180-month period, beginning with the initial month of operation. The deduction is reduced by the amount of start-up costs that exceed $50,000. If the total start-up costs are $55,000 or more, the initial deduction is reduced to zero, but the company may still amortize its start-up costs over 180 months.

The nature of an expenditure as a currently deductible expense must also be substantiated. Generally, costs for items that have a useful life of more than one year must be capitalized and depreciated over time, rather than expensed immediately. When deducting an expense, the taxpayer has the burden of showing that capitalization was not required.

In addition to substantiating the amount and payment details regarding a business expense, the specific business purpose of the expense must be demonstrated as well. In some cases, the nature of the expense itself will be self-evident. Often this is not the case, as with business meals, travel expenses, and other types of expenditures that could just as easily be viewed as personal in nature. Generally, an adequate record of the business purpose of an expense must be in the form of a written statement. The amount of detail necessary to establish a business purpose depends on the facts and circumstances of each case.

The IRS allows for some flexibility with this requirement. The agency allows some minimal personal use for an otherwise business deduction. For example, a stop for lunch between two business appointments will not render the travel to the appointments non-deductible. Also, the IRS does not require a written explanation of the business purpose if it can be determined from the surrounding facts and circumstances. For example, a salesperson visiting customers on an established sales route will not normally need a written explanation of the business purpose of his or her travel.

Perhaps things would have ended up differently for Matthew Peterson if he had been more familiar with the necessity of establishing a business purpose for each expense.[21] Matt worked full-time as a police officer for the city of Chicago. Apparently feeling that this job protecting the citizens of the windy city did not endanger his safety enough, Matt decided to start his own specialized security services company called Peterson Security. Matt was the sole owner and employee of Peterson Security.

One of the benefits of working for the Chicago Police Department was that the department gave Matt a free bulletproof vest, assigned him a police car, and paid for gas for the car. His employer also made some off-duty training opportunities available to him that were not specifically required for his position with the department.

On his 2011 and 2012 returns, Matt claimed tens of thousands of dollars in unreimbursed employee expense deductions on Schedule A for parking fees, tolls, and other transportation expenses. On Schedule C Matt reported $6,680 of gross receipts and $15,986 of expenses. Matt's Schedule C expenses included expenses for meals and entertainment, travel, office expenses, and protective clothing.

Matt claimed that he incurred his Schedule A expenses while driving to his off-duty training and education. While this training and education were not required by his employer, it was provided to Matt as a result of his employment as a police officer, and it is not hard to imagine that such activities may have contributed importantly to his employment duties. However, he did not provide any other details of this training or education. The only documentation Matt provided to substantiate his Schedule A deductions was his bank statements. The Tax Court sustained the IRS's disallowance of all these expenses, stating that the bank statements fail to substantiate them since they only showed amounts paid, not a description of the business purpose.

The IRS allowed Matt's Schedule C deductions for vehicles, machinery and equipment, supplies, utilities, and protective clothing. However, the IRS disallowed Matt's Schedule C expense deductions for travel, office, and meals and entertainment expenses.

Matt claimed that he was entitled to over $2,000 for meals and entertainment expenses since he incurred these expenses while meeting with various individuals to discuss expanding, marketing, and advertising Peterson Security. Matt provided a non-contemporaneous expense log to substantiate the expenses. However, because the log did not describe the business purpose of the expenses, and there was no other corroborative evidence for these expenses, the Tax Court disallowed the deductions for these expenses. Matt also provided a non-contemporaneous expense log

to support the over $5,000 in office expenses he incurred, as well as non-contemporaneous travel logs to support his $4,000 in travel expenses. He stated that he incurred his travel expenses developing business and completing business assignments for Peterson Security, but did not provide any other evidence to corroborate his travel expenses.

In this case, the non-contemporaneous nature of the records was not the fatal flaw. What sunk Matt was that he failed to adequately describe the business nature of the expenses, and as a result, the Tax Court disallowed them.

Despite Richard Canatella's extensive experience with the law, he ran into a similar problem with respect to substantiating his deductions.[22] Richard was a California lawyer who practiced as a sole proprietor. In 2007 Richard's practice generated gross receipts of approximately $440,000 and he claimed almost that amount in expenses. The expenses listed on his return included items you would normally expect: advertising, contract labor, and rent. The largest expense item listed, however, was almost $260,000 for "other" expenses.

Richard's return was audited and the revenue agent asked him for certain documents to substantiate the items appearing on the return. Richard failed to produce many of those documents but did provide the agent with canceled checks and credit card statements confirming that he had, in fact, made the payments in question. Nonetheless, the IRS disallowed $338,048 of the deductions.

Outraged, Richard vowed to fight the IRS and took his case to Tax Court. Confident in the sufficiency of his substantiation. In addition to his canceled checks and bank statements, Richard produced schedules showing, by month and type of expense, the total amount that he claimed as a deduction in carrying on his law practice. In addition, he also submitted to the court a detailed report cataloging these expenses. Together, Richard felt sure these documents indisputably substantiated his claimed deductions and that the Tax Court would tell the IRS in no uncertain terms that those deductions should have been allowed. The IRS, Richard believed, had picked the wrong taxpayer to mess with.

When the trial date arrived Richard dutifully presented himself to the court. After opening statements, the Tax Court judge took up the issue of the expenses. "Okay," the affable Judge Chiechi began, "let's move on to each of the expenses and I'll tell you what they are, just in the order in which they were in the statutory notice of deficiency." The Judge embarked on the litany of claimed deductions: "Meals and entertainment of $2,436, what do you have to tell me in support of your position that the entire amount is deductible"?

Richard did not have the patience for this. Why not just cut to the chase? His entitlement to the deductions could not be more clear. "As far as I'm concerned," Richard retorted, "every expense is allowable, and if the examiner didn't allow it, it's because he didn't accept canceled checks, bank statements, and documentation that prove . . . that we're entitled to the allowance." That should set them straight, no doubt thought Richard, anticipating that the Judge would take his cue to lay into the IRS attorney for disputing the obvious.

"So you believe that having a canceled check or a credit card statement entitles you to each of the deductions, is that right?" Judge Chiechi asked, incredulously. Undoubtedly understanding the Judge's question as a mechanism to emphasize the point to the IRS and teach them a thing or two about denying legitimate deductions, Richard held his head high and proclaimed "Yes!"

Richard's bravado, however, may have been somewhat misplaced. Despite his confidence that merely establishing that he had, in fact, paid certain amounts entitled him to a deduction, he was sorely mistaken. Quite to the contrary, that belief reflected, in the words of the court, "a misunderstanding, or a disregard, of the requirements of section 162(a)."

The IRS never disputed the fact that Richard had actually made the payments in question. What Richard failed to understand was that his case was not about establishing the ***fact*** of the payments. That is merely a threshold question. In order to be entitled to a deduction for business expenses, the taxpayer has to establish not only that he or she made the payments, but also that the expenses represent ***ordinary and necessary expenditures*** for carrying out the business. If Richard had grasped that concept, he may have put together a more successful case.

It is unknown whether Richard Canatella could have successfully substantiated the business nature of his claimed expenses. He apparently did not even try, however, because of his failure to understand the fundamental concept that proving payment alone is not enough.

This is a lesson that must be driven home to every taxpayer, and every professional that advises them. Business deductions are not just about the "what," they are about the "why." Substantiating that an expense was actually incurred is generally relatively easy through canceled checks and credit card statements. It is the substantiation of the "why," the business purpose of the expense, that often proves difficult. If Richard Canatella had understood this, he would have saved himself a lot of trouble.

DEDUCTIONS SUBJECT TO STRICT SUBSTANTIATION

Overview

Certain business deductions described in Code Section 274 are subject to strict rules of substantiation.[23] These deductions include: (a) any travel expense, including meals and lodging away from home; (b) for any expense for gifts, or (c) the use of any "listed property."[24] Listed property includes any property used as a means of transportation or for entertainment, recreation, or amusement purposes. It also includes any computer or peripheral equipment that is not used exclusively at a business or owned or leased by the person operating the business.[25] For an expense described in one of the aforementioned categories, the taxpayer must substantiate by adequate records or sufficient evidence to corroborate the taxpayer's own statement: (1) the amount of the expenditure or use, using the appropriate measure (mileage may be used in the case of automobiles); (2) the time and place of the expenditure or use; (3) the business purpose of the expenditure or use; and in the case of business gifts, (4) the occupation or other information relating to

the recipient of the gift, including name, title, or other designation, sufficient to establish a business relationship to the taxpayer.[26]

Christopher Stanback—a production assistant in the film, television, and commercial industry—had trouble meeting this requirement.[27] In this role, he assisted in the production of television shows, commercials, or films, performing tasks such as making copies, filing, or getting lunches for actors. He did not receive any payment for travel expenses.

In 2010 Chris was asked to travel from his apartment in New York to Hawaii to work on the pilot episode of a television show. The show was selected for production, and he was offered a job as the prop master's assistant. As a result, he moved to Hawaii in July 2010. Unfortunately, Chris was unable to break his apartment lease in New York. In addition, he decided to keep his internet service there in case he needed it. Because his ground-floor apartment had windows abutting an alley, he feared leaving his personal items there and instead put them in storage.

He left the television show in Hawaii in November 2010. From December 2010 to January 2011 Chris went to Prague, Czech Republic, to "teach and learn" at a film school under an exchange program. He was provided with room and board, but he had to pay his own travel expenses. He was in Prague for about three weeks. Chris went back to New York for a few jobs and continued to pay for his New York storage unit through November 2011.

In November 2011 Chris's apartment lease was about to expire. As a result, he traveled to New York to cancel his Internet service and retrieve his belongings from storage. After donating and storing some of his items, Chris packed his remaining items, including his tax information, in a large Craftsman trunk and flew to Los Angeles. Somewhere along the way, his trunk was damaged by the airline or airport workers, and the contents were mostly lost or destroyed.

Chris claimed deductions for travel expenses of $6,306 and utility expenses of $3,230 on his 2010 return. His 2011 tax return included charitable contributions of $10,400, and miscellaneous itemized deductions of $16,265 before the application of the 2% floor required by Code section 67. The IRS disallowed all these deductions, except for $1,766 of his unreimbursed employee expenses.

For substantiation of his utility expenses, Chris presented copies of electric bills from his New York apartment in 2010 totaling only $56.88. He explained that the expenses for utilities were business expenses because he had to maintain his apartment in New York while living in Hawaii. He had to maintain his apartment, he testified, because he had "unfinished business" in New York, and he needed the internet service and electricity to run it. Also, he could not afford to break his lease. The court found that Chris had not adequately substantiated the $3,230 claimed for utility expenses, or shown that they were business, as opposed to personal expenses.

In order to substantiate his travel expenses, Chris prepared a summary list of his travel locations. The list included the following categories: reason/job, arrival and departure dates, and round number estimated costs that included airfare and hotel costs. Chris stated that he could not obtain any more pertinent records because small banks and credit card

companies get sold to bigger companies and "they dissolve the assets and keep the records God knows where." The court was not swayed by this compelling explanation and held that the documentation did not meet the standard of substantiation required by Code section 274.

Chris fared no better with respect to the substantiation of his unreimbursed employee business expenses. He provided copies of credit card statements and some bank statements for 2011 that, without further explanation, appear to show personal expenditures. Because Chris offered no evidence of the business purpose of these expenditures, the deductions were disallowed.

The strict substantiation requirements present an additional hurdle for deductions, but they are certainly not impossible to meet, as Mark Pelot demonstrated (at least in part) in his case. Mark was employed as a fire investigator by Certified Investigations International, Inc.[28] His job included conducting investigations regarding the causes of fires, interviewing fire department employees and people who lived or worked where the fires occurred or in the immediate area, and preparing and reviewing reports. The nature of his work often required that he traveled to locations away from Certified Investigations' main office to examine the site of a fire or interview relevant parties. He used one personal vehicle exclusively for work-related transportation and a different personal vehicle for non-work-related transportation. His company did not reimburse employees for transportation, vehicle, or any other expenses.

Mark maintained a log containing information about fires investigated by Certified Investigations that included the address of each fire and the investigator assigned to it. He also maintained a contemporaneously prepared log of his daily activities that included (in part) the file number of each fire, the street name, the activity performed, and his start and end times for each activity. Mark recorded his odometer readings. Occasionally, he attended conferences related to the science of fire investigations.

Mark claimed deductions for vehicle expenses, parking fees, tolls, travel expenses while away from home overnight for conferences, meals and entertainment expenses, and other business expenses on Schedule A as unreimbursed employee expenses. Upon audit by the IRS, Mark failed to offer any substantiation for expenses related to his parking fees, tolls, overnight travel expenses, and other business expenses. As a result, the IRS disallowed his Schedule A employee business expenses entirely for lack of substantiation.

He prevailed in Tax Court, however, with respect to the vehicle expenses he claimed using the standard mileage rate. The court noted that Mark's testimony describing his daily activities and responsibilities during the course of his employment was consistent with the information contained in his mileage logs.

Not surprisingly, the court disallowed the claimed expenses for which Mark failed to provide receipts, canceled checks, bank records, or similar records to substantiate the expenditures. In addition, he did not testify or offer secondary evidence regarding the expenditures. The court also sided with the IRS with regard to his travel expenses while away from home overnight. Although the court acknowledged that the conference related to the science of fire investigations was related to his work, Mark did not provide any documentation or other persuasive evidence

regarding most of these expenses. He did provide documentation for the costs of registration at the conference and a fingerprint check, and the court allowed those expenses.

This case clearly demonstrates the crucial nature of strict substantiation. Mark Pelot almost certainly had incurred deductible expenses beyond those which were allowed by the IRS and ultimately sustained by the Tax Court. In his case, he was vigilant with respect to substantiating his vehicle expenses but lacked the same discipline with respect to the other expenses he incurred. Strict substantiation means just that—while in this case, it seems that the court believed Mark had incurred additional expenses, but without compliance with the strict substantiation rules its hands were tied.

Strict Substantiation for Vehicle Expenses

Taxpayers are expected under the strict substantiation rules to maintain and submit documents with detailed mileage information for vehicle expenses, as well as other documents corroborating these expenses if they want to prevail with respect to deductions. Specifically, vehicle expenses that are deducted as business expenses will be disallowed in full unless the taxpayer substantiates the expenses by adequate records or other corroborating evidence of (1) the amount of each use (***i.e***., the mileage), (2) the time and place of the use, and (3) the business purpose of the use.[29] In the absence of adequate records to substantiate an element of an expense, a taxpayer may establish an element of his or her own statement, whether written or oral, containing specific information in detail as to such element and by other corroborative evidence sufficient to establish such element. The key is providing the requisite detail.

Jim Chapin operated his own real estate sales business.[30] In order to keep track of his car and truck expenses, Jim kept two documents. The first document, titled “2009 Mileage Chart”, was a handwritten list of places that the taxpayer alleged he had driven. The list neither indicated any business purpose for the trips nor reported the mileage traveled or the amount of each trip expense. The second document, titled “Itemized Categories”, was a printed list of expenses for his SUV. This document listed purported expenses in 2009 for fuel, insurance, parts, registration, and service, and it included an amount for each entry. He also wrote the total number of miles for the year on his “Itemized Categories” document.

Jim deducted $5,309 of car and truck expenses on Schedule C, ***Profit or Loss From Business***. The IRS disallowed the car and truck expenses based on Jim’s failure to substantiate vehicle expenses as required by Code section 274.

The Tax Court found for the IRS, holding that Jim’s “2009 Mileage Chart” and “Itemized Categories” documents were inadequate to substantiate the expenses. The main reason the court found this was because neither document identified a business purpose for each trip or showed mileage. The court held that the handwritten note with Jim’s total mileage listed was insufficient to substantiate the mileage because it did not show the mileage of each trip or how the mileage was allocated between business and personal use. The court also noted that Jim was unable to provide any corroborating receipts or other records for further substantiation.

Substantiation in the Case of Unforeseen Circumstances

A taxpayer can avoid having to meet the adequate records requirement by showing that he or she is unable to produce adequate records due to circumstances beyond his or her control, such as destruction by fire, flood, earthquake, or other casualty. In this case, the taxpayer is allowed to substantiate deductions through any reasonable reconstruction of expenditures but is required to reconstruct pertinent records to the fullest extent possible.[31] If no other documentation is available, the court may, but is not obliged to, accept the credible testimony of the taxpayer to substantiate a deduction.[32] The Tax Court is not bound to accept a taxpayer's unverified, undocumented testimony.[33]

This rule worked to the detriment of Dionne Chisolm. Dionne was a full-time program analyst for the Department of Homeland Security.[34] In her free time, she worked in real estate, albeit pretty unsuccessfully as she did not report any significant profits. As was her custom, she gathered her receipts and provided them to her tax preparer. The return prepared for Dionne claimed over $100,000 in business expense deductions relating to advertising, car and truck, insurance, office, meals and entertainment, and other expense. Shortly after preparing these tax returns, Dionne's tax preparer passed away. When her returns were later audited, she did not have physical possession of any of her tax records. The IRS disallowed the deductions, and Dionne petitioned the Tax Court.

Dionne claimed that there existed records to substantiate the expenses. However, she had given those records to her tax preparer and had been unable to retrieve them from the family or estate. Although the court assumed that Dionne was telling the truth, the court nonetheless disallowed the deductions since there were no corroborating records or credible testimony.

A taxpayer in Dionne's situation should endeavor to reconstruct expenses as diligently as possible, such as by obtaining duplicate receipts, bank or other records consistent with the deductions, or even testimony of others who had knowledge of the expenditures. The taxpayer should never assume the IRS or the court will sympathize with him or her and allow deductions based on their uncorroborated testimony alone.

Unreimbursed Employee Business Expenses

NOTE: The TCJA suspends all miscellaneous itemized deductions subject to the 2% floor for tax years 2018 through 2025.

As described before, being an employee is itself considered to be a trade or business. If an employee incurs business expenses as part of his or her employment that are not reimbursed by the employer, a deduction may be taken on Schedule A (subject to the 2% floor for miscellaneous itemized deductions). With respect to unreimbursed employee business expenses, the taxpayer has to show that the expense was not subject to reimbursement from his or her employer. An expense is not deductible as ordinary and necessary to the extent that it was subject to reimbursement by the employer.[35]

Michael Tocher did not realize this when he and his wife filed their tax returns in 2011.[36] Michael was an engineer employed by a company called Winzler Kelly. His wife worked in the real estate business. On their Federal income tax return for 2010, the couple attached Schedule A and Schedule C deductions. They deducted $10,646 of employee business expenses and certain miscellaneous deductions on Schedule A for Mr. Tocher's expenses. On Schedule C Mrs. Tocher reported gross income of $1,733 and deducted car and truck expenses in $27,212. The IRS disallowed these expenses.

The Tax Court found for the IRS. The court found that the Tochers were not entitled to Schedule A deductions for Mr. Tocher's expenses because they failed to show that his employer would not have reimbursed him. The court denied Mrs. Tocher's vehicle expense deductions for lack of proper substantiation.

For Mr. Tocher's unreimbursed employee business expenses, the couple provided the court with a document titled "Silverado Mileage Log 2010" and assorted receipts for expenditures including for food, car rentals, electronics, hotels, parking and airfare. The mileage log showed miles driven to various "Client Events" between July and December 2010 said to be "Non-reimbursed". The court reiterated the rule that an expense is deductible as ordinary and necessary to the extent that it was not subject to reimbursement by the employer. The court found there were two pages from the taxpayer's employer document that stated preapproved travel expenses that are reasonable and documented will be reimbursed. However, the taxpayer testified that he did not seek reimbursement from his employer for the expenses deducted on the return because he "elected not to." The court decided the taxpayer could not deduct such expenses because the taxpayer has failed to demonstrate that his employer would not have reimbursed his expenses had he made a proper request.

As for the Schedule C car and truck expenses, the court reviewed whether Mrs. Tocher met the standard of substantiation required by IRC §274 because the expense fell under the category of "listed property", which could be the passenger automobile. Mrs. Tocher testified that she used one vehicle to show properties and the other to preview properties.

Mrs. Tocher provided copies of two one-page printouts, one entitled "Pontiac Mileage Log 2010" and the other, "PT Cruiser Mileage Log 2010", as evidence of her automobile use. The logs aggregated mileage by the week, and every weekly entry described the mileage as "Tracy-Real Estate-Viewing Properties". There was no further identifying information in the logs. The logs did not reveal which property was being viewed, the date and time, the location or distance of the property viewed, or the client, if any, related to the viewing. Mrs. Tocher supplemented her logs with copies of "Auto-Prospecting Email Reports" that were sent to her listing properties for sale in March 2010. In addition, she offered copies of a "Listing Summary" for 16 properties sold on unstated dates by unnamed agents.

The court found that Mrs. Tocher failed to connect the supplementing documents with the log except to testify that she went to view approximately 40% of the properties in the auto-prospecting email reports. Therefore, she did not meet the standard of substantiation required by Code section 274.

Start-Up and Other Special Types of Expenditures

Generally, start-up expenditures cannot be immediately expensed but must be capitalized and recovered over a 60-month recovery period. An exception exists if a timely election is made under Code section 195 to expense a limited amount of those costs. In this case, not only must the expenses be properly documented, but so must the adequacy of the election.

Code section 195(b)(1) allows for a deduction of up to $5,000 in start-up costs (limitations apply when start-up costs exceed $50,000) in the first year of the business, with any remaining start-up costs being amortized over a 180-month period, beginning with the initial month of operation. The deduction is reduced by the amount of start-up costs that exceed $50,000. If the total start-up costs are $55,000 or more, the initial deduction is reduced to zero, but the company may still amortize its start-up costs over 180 months.

Mary Fisher and her husband, Charles Patterson ran into problems substantiating the nature of their deductions and the fact of their Code section 195 election.[37] Mary and Charles operated a horse-racing and horse-breeding business called Arabian Hill Horse Park in Virginia. Prior to commencing operation of Arabian Hill, the couple acquired horses and related assets, estimating that they incurred startup expenditures of over $20,000, including costs for research and viability assessment, locating assets, and seminars. Upon examination, the IRS disallowed Mary and Charles's claim for amortization deductions, asserting that the couple had failed to make a timely election under Code section 195 and that they had failed to adequately substantiate the claimed expenditures.

Although they did not provide the IRS with any evidence of an election during the audit, at trial, Mary and Charles attempted to prove that they made a timely election to amortize start-up expenses on an earlier return by introducing a completed Form 4562, ***Depreciation and Amortization***, as well as accompanying workpapers purportedly drafted while preparing that return.

The Tax Court was troubled by their failure to provide the IRS with the documentation concerning the election to amortize start-up expenses until the date of trial. Furthermore, the court found the documents to be insufficient for the purposes of satisfying the burden of proving that the election was properly made, particularly since they did not include the actual tax return, but only Form 4562 and workpapers. The court pointed out that it is not required to accept a taxpayer's self-serving testimony, and they declined to do so in this case, finding that Mary and Charles failed to meet their burden of proving that they had executed a timely election to amortize start-up expenditures. Due to their inability to substantiate this election, therefore, the couple was not entitled to amortize the startup expenditures.

To substantiate the amount of their purported startup expenses, Mary and Charles provided a list of the various expenditures incurred up until the date on which they officially commenced operation of Arabian Hill, as well as various credit card receipts. Although the credit card receipts indicated that they had incurred expenses related to their horse-breeding and racing activities prior to commencing operations, the information contained in the

statements, was not sufficient to discern which charges represented deductible expenses, as distinguished from those constituting capital expenditures.

The list of expenditures was not compiled contemporaneously with the expenses and consisted mainly of estimates rather than verified amounts. Needless to say, the list was inadequate for the purposes of substantiating the expenses in question, in large part because it was not contemporaneous. A list compiled simultaneously with the incurrence of each expenditure may have had some probative value, but otherwise, it was really nothing more than a list of self-serving estimates. If a taxpayer is going to rely on a self-created list to substantiate expenditures, at the very least it should be contemporaneous and specifically detailed.[38]

Another area where taxpayers sometimes run into trouble is with substantiating the nature of research and development expenses. The Code allows a taxpayer to immediately deduct expenditures, even if they would otherwise be considered capital in nature if they are "research and experimental" as described in Code section 174. To qualify for the deduction under Code section 174, the costs must constitute research in the "experimental" or "laboratory" sense.[39]

Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Research or experimental expenditures may include the cost of developing computer software.

Substantiating research or experimental expenditures became a problem for Tom Johnson, an aspiring inventor and entrepreneur, who developed software constituting a "nutritional information system" designed to help grocery shoppers select food based on its nutritional value.[40] To this end, he retained the services of a consultant who reviewed the scientific literature on various nutritional issues, translated the literature into laypersons' terms, decided how to deliver nutritional information to the consumer, gathered nutritional information on various food products, reviewed several newsletters and journals related to nutrition, used her contacts at large corporations to obtain nutritional information on their products, reviewed computer magazines and manuals, and organized a group of college students to test Tom's system.

The consultant also attempted to simplify nutritional data contained in a database managed by the U.S. Department of Agriculture. Tom accompanied the consultant to conferences related to nutrition or nutritional data banks. The

problem for Tom was that none of these activities indicated that the consultant engaged in research in the experimental or laboratory sense, nor did they constitute the development of computer software.

In fact, Tom failed to substantiate that he ever developed any computer software. He submitted five letters he received from various grocery executives relating to the nutritional system in which the executives made various references to his “demonstration notebook,” “proposal,” “program,” and “write-up.” Apparently what they were referring to was a notebook compiled by Tom titled “The Food Comparison Machine,” which explained his system.

Supposedly, the pages in the notebook illustrate what would appear on a computer screen, but the Tax Court found that the illustrations alone did do not qualify as the development of computer software. To further bolster Tom’s claim that he was entitled to research and development expenses, he submitted a letter from an attorney regarding the patentability of his system. Nothing in the letter, however, indicated that Tom was developing computer software during the years at issue.

It may have been that some of the nutritional information culled by the consultant found its way into the notebook. However, Tom had no evidence of coupling the various expenditures to any research or experiment in nutritional science or computer software. In Tax Court he repeatedly described his activities as the development of computer software. However, the court felt that the evidence produced simply did not support this characterization of his activities, and his subjective belief did not constitute substantiation. Therefore, the Tax Court concluded that the expenditures were not deductible as research or experimental expenses under Code section 174. Accordingly, they did not even have to consider whether those expenditures were in connection with a trade or business or whether a proper election was made.

Substantiating Home Office Deductions

Generally, no deduction is allowed for the taxpayer’s business use of his or her own home. This general prohibition, however, does not apply to the extent an expense is allocable to a portion of the taxpayer’s home that is ***exclusively*** used on a ***regular*** basis as either: (1) the principal place of business for any trade or business of the taxpayer; or (2) a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his or her trade or business. Additionally, a deduction may be taken in the case of a separate structure that is not attached to the dwelling unit, if it is used in connection with the taxpayer’s trade or business.[41]

The law provides taxpayers with two options for determining the amount of the home office deduction. Under the traditional method, the taxpayer must substantiate each expense that is allocated to the home office, such as utilities, mortgage interest, depreciation, etc. Revenue Procedure 2013-13 provides a second, safe harbor method. The safe harbor amount is $5 per square foot of qualified use up to 300 square feet, resulting in a maximum deduction of $1,500. Other than being limited to the income generated by the trade or business income of the taxpayer, the traditional method is not subject to any specific dollar limitation.

When claiming a deduction for a home office under either the safe harbor or the traditional method the taxpayer must substantiate the fact that the home office is actually used for business. While there is no specific time requirement, there should be some documentary support that business activities are being conducted there on a regular basis.

Back in the 1980s, Tom Johnson began developing a nutritional information system that he called the “Food Store.”[42] He envisioned nutritional information stored in a computer to help grocery shoppers select food based on its nutritional value. Among the expenses he deducted on Schedule C were amounts listed as “utilities” and “rent or lease.” Tom contended that these expenses related to the business use of his home.

The only evidence he offered in this regard, however, was his wife’s testimony that one room in their home was used by Tom as an office. The specific business activities conducted in the home office were not detailed, nor was there any substantiation of the number of hours spent in the home office for business purposes. Because Tom did not substantiate the regularity with which he used his home office, the deduction was denied.

Substantiating Material Participation

Deductions emanating from passive activities are generally limited to, income realized from passive activities during the same tax year. An activity is not passive, however, if the taxpayer establishes that he or she “materially participated” in the activity. Material participation is demonstrated by meeting one (or more) of the following seven tests:

1. Participation in the activity for more than 500 hours during the year;
2. The taxpayer’s participation was substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity;
3. Participation for more than 100 hours during the tax year and this was at least as much as any other individual (including individuals who did not own any interest in the activity) for the year;
4. The activity is a “significant participation activity” for the tax year, and the taxpayer’s aggregate participation in all significant participation activities that year exceeds 500 hours (a “significant participation activity” is a trade or business in which the taxpayer participates for more than 100 hours, but in which he or she doesn’t otherwise materially participate);
5. Materially participation in the activity for any five tax years (consecutive or not) during the 10 immediately preceding tax years;
6. The activity is a personal service activity in which material participation for any three tax years (consecutive or not) before the tax year; or
7. Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.[43]

It should be noted that activity performed in an individual’s capacity as an investor does not qualify as participation in an activity unless the individual is directly involved in the day-to-day management of the activity. Investor-related

activities not qualifying as material participation include: (1) studying and reviewing financial statements or reports on operations; (2) preparing or compiling summaries or analysis of the finances or operations of the activity for the individual's own use; and (3) monitoring the finances or operations of the activity in a non-managerial capacity.

This is yet another reason it is especially important for taxpayers to document the specific nature of their activities, not just the time spent. A taxpayer named Al Iverson unwittingly provided a case in point. Despite the fact that Al and his wife formed Stirrup Ranch, LLC to run a 42,000 acre Colorado cattle and horse ranch, they were deemed by the Tax Court to be mere investors in the ranch and the losses sustained by the undertaking were held to be passive.

It's not that Al had no involvement in the ranch. From his home in Minnesota, he would make and receive telephone calls and send and receive emails and faxes relating to Stirrup Ranch matters. He retained for himself Stirrup Ranch check signing authority, although occasionally he would grant a power of attorney authorizing the ranch manager to sign Stirrup Ranch checks. During the years in question, Al made monthly trips to the ranch and while there would assist the ranch manager and ranch hand with various ranch chores, such as mending fences, rounding up cattle, branding, inoculating, and castrating cattle, and cleaning the barn.

The tax advisor that Al used, was an attorney, a certified public accountant, the director of a regional accounting firm, and a former IRS employee. That advisor concluded that Al materially participated in the ranch activity. The IRS and the Tax Court disagreed.

Despite the fact that Al's trips to the ranch were all documented, as were some of his ranch-related activity while in Minnesota, the court cited the lack of "meaningful contemporaneous or other records and documentation regarding specifically what petitioners did on a day-to-day basis and how much time they spent on matters relating to Stirrup Ranch." The court states that it would have given more credence to the taxpayer's claims if they had been able to present "extensive files, to-do lists, home and mobile phone records, business plans, project descriptions, instructions to employees, etc."

REAL ESTATE RENTAL ACTIVITIES

Background

It is particularly important to keep detailed records with respect to rental property. Rental activities are automatically considered to be passive, so any losses can only offset passive income until the rental activity is entirely disposed of. If an adjusted gross income threshold is met, a taxpayer may be able to offset a limited amount of non-passive income from rental activity losses. Specifically, a taxpayer may deduct up to $25,000 in rental real estate losses against non-passive income as long as he or she actively participates in the rental real estate activity and their income is below the AGI threshold. The $25,000 amount is reduced by 50% of the amount by which the taxpayer's annual adjusted gross income exceeds $100,000. For married taxpayers filing a separate return, only $12,500 is available to offset non-

passive income, reduced by 50% of the amount by which the taxpayer's annual adjusted gross income exceeds $50,000.

This so-called "small landlord" exception is not the only way around the limitation on deducting losses from rental activities. Code section 469(c)(7) provides that such losses may be deducted against non-passive income under some circumstances if the taxpayer meets certain requirements, establishing their status as a "real estate professional." When such status is established, losses from rental activities in which the real estate professional materially participates may be deducted, presuming the expenses giving rise to the losses are adequately substantiated.

A taxpayer qualifies as a real estate professional if: (1) more than one-half of the personal services performed in trades and businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. Code section 469(c)(7)(D)(ii) generally precludes services performed by an employee who is not a 5% owner from being treated as performed in a real property trade or business. In the case of a joint return, these requirements are satisfied only if either spouse separately satisfies these requirements. "Real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Therefore, with respect to the deduction of real estate rental losses on the basis that the taxpayer is a real estate professional, three separate things must be substantiated. In addition to the normal substantiation requirements for the expenses themselves, the taxpayer must prove that he or she is entitled to real estate professional status and that he or she materially participated in the specific activity giving rise to the loss.

For example, Brad Hershberger supplemented his income working for the local Wichita airport by renting out three residential properties he owned.[44] On his return Brad reported about $10,000 of income from these properties and repair expenses of about $18,000. The IRS disallowed Brad's repair expenses for lack of substantiation and included additional rental income because of the unexplained deposits in his bank account records. Brad filed a Tax Court petition to contest these adjustments.

The Tax Court sided with the IRS, finding that Brad underreported his rental income. The court also disallowed deductions for rental repair expenses, on the basis that he hadn't disproven evidence of unreported income from bank deposits or substantiated the deductions.

Brad produced receipts to substantiate his repair expenses. However, the court found these receipts to be too vague since they did not include the nature and date of the repairs, the name of the individual or company that performed the repairs, the details concerning what work was performed, or the type of materials used in the repairs. The receipts were also printed on blank paper rather than on the official letterhead of a business. There was also no verification of

the cost of repairs or receipt authentication of the people who performed the repairs. As a result, the IRS found the receipts to not be credible, and not meet the substantiation requirement.

As always, the burden is on the taxpayer to prove an entitlement to a deduction. Take the case of Edgar and Julia Flores, a couple from Illinois whose Tax Court case was decided in January of 2015. During 2011 Edgar and Julia owned a townhouse approximately 17 miles from their primary residence. They rented out the townhouse or held the property out for rent throughout the entire year. Edgar managed, renovated, and repaired the property, doing all of the work himself.

Julia worked full-time, at least 1,800 hours, for Chicago Nut & Bolt Co., Inc., a manufacturer of industrial and intricate custom fasteners whose business does not include the development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage of real property. She was also the treasurer of the Bill George Youth Football League. Edgar worked at least 1,294 hours for AC Pavement Striping Co., which provides specialized pavement markings and cost-effective pavement preservation practices for all types of roadways. Like Chicago Nut & Bolt, AC Pavement Striping's business does not include the development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage of real property.

On their Schedule E, Edgar and Julia reported $15,648 of rental income and $26,138 of expenses. The expenses consisted of $250 for advertising, $150 for cleaning and maintenance, $970 for insurance, $130 for legal and other professional fees, $300 for management fees, $15,085 for mortgage interest, $3,688 for taxes, $5,015 for depreciation, and $550 for other expenses.

The couple contended that Edgar was a real estate professional. Edgar's employer was not engaged in a real property trade or business; even if it was, Edgar's work there would not count toward his status as a real estate professional because he was not a 5% owner. Since he spent 1,295 hours working for AC Pavement Striping, he had to show that he spent more than that amount of time on real estate trades or businesses to qualify for the first prong of the test.

In order to prove their case, the couple introduced into evidence a calendar that identified the dates and times that they contended Edgar spent working on the townhouse. They also produced a summary that computed on the basis of the calendar the total number of hours he worked. According to this calendar, and summary, Edgar spent a total of 799 hours working on the townhouse.

They also introduced a log into evidence. Edgar testified that the hours in this log consist of time spent traveling, performing bookkeeping and maintenance, and researching other properties to purchase and rent out. He admitted, however, that the entries indicating that he spent four hours doing bookkeeping were inaccurate.

There was also testimony about a second calendar that they claimed identified additional hours that were not included in the first calendar. Unfortunately, Edgar's testimony about the second calendar was inconsistent with the first

calendar. According to his testimony, there are more hours identified in the second calendar and they reflected the hours of both the first calendar and the log that were admitted into evidence.

The court was confused by Edgar's testimony, deciding that they could not tell from it how he spent his time at the townhouse. The entries in the first calendar and the log were vague. Their estimates were uncorroborated and did not reliably reflect the hours that Edgar spent working on the townhouse. Ultimately, the court did not find Edgar's testimony to be credible.

Even if the court were to assume that the first calendar and summary were correct, Edgar did not spend more time working on the property than he did as an employee of AC Pavement Striping Co. Therefore, he did not qualify as a real estate professional and there was no evidence that Julia did. As a result, the couple's rental real estate loss deduction was disallowed pursuant to the passive activity loss rules.

Bill Lewis, a disabled Vietnam veteran from California, had better luck when his case was decided at the end of 2014. During his service in the Marine Corps, Bill sustained injuries that left his right arm 50% disabled and his feet 30% disabled, requiring him to wear orthopedic shoes. The Department of Veterans Affairs determined that he was 60% disabled, and he received monthly veterans' disability assistance. At the time of his Tax Court case, he was also in need of knee replacement surgery and had difficulty seeing. Bill was 63 years old.

Bill and his wife owned a triplex apartment that is next door to their residence. They began renting out the triplex units to tenants in 2007. For two years the Lewises experienced losses from the triplex that they deducted on their return. The IRS asserted that these were passive activity losses and could not be deducted until the triplex was disposed of.

The couple did not permanently employ anyone to aid in the process of renting out the units or maintaining the property. Rather, Bill personally performed administrative tasks, routine maintenance, and repairs. During the years in issue, he was available to his tenants 24 hours a day when they had a lockout or needed repairs. He also collected the rent checks. Each of the tenants paid his or her rent on a different day of the month. When Bill collected each tenant's rent he would drive to the bank to deposit the funds.

Bill performed the same weekly routine during each of the years in issue without ever taking a vacation. Each morning he would walk around and inspect the grounds for trash left behind by the homeless population. On Mondays, he would clean the washhouse that w in the back of the property. On Tuesdays and Fridays, he would landscape and clean the outside of the buildings, the garbage cans, and the front yard. Depending on the season, this chore would also require him to rake fallen leaves from the several walnut trees and sweep the fallen walnuts and shells left behind by squirrels. On Wednesdays, he would take all of the recycling bins, one by one to the curb. On Thursdays, he would retrieve the recycling bins, one by one, that he placed at the curb the night before.

Given the fact that Bill was not otherwise employed, he clearly spent more than half of his personal service time on the rental property; the only remaining question as to the first prong of the test was whether his activities constituted

material participation. In that regard, Bill testified that he performed almost all of the necessary work related to the rental of the triplex himself. He collected the rents, maintained the property daily and weekly, and handled all maintenance requests. He did not have any employees. At times Bill hired contractors to perform specified work; these instances were infrequent and insignificant compared to the daily work that he performed.

As a result, the court found that Bill satisfied this test because his participation constituted substantially all of the participation in the rental of the triplex. Because Bill was a creature of habit he was able to show that his activities were regular, continuous, and substantial. That left only the 750-hour requirement between the Lewises and their loss deduction.

While there was no contemporaneous daily report, Bill and his wife each provided the Tax Court with a narrative summary regarding Bill's activities and the approximate number of hours spent performing those activities. They testified that all of the activities took Bill significantly longer than usual because of his disabilities.

Regarding his routine repair activities, Bill testified that his daily morning inspection of the property took at least half an hour, or 3-1/2 hours each week. He testified that his Monday washhouse cleaning took three hours as it required him to haul a heavy bucket of water and perform the manual labor of cleaning. He testified that each Wednesday it took him at least an hour to haul all six of the recycling bins from the back of the triplex to the curb and that it took the same amount of time each Thursday to return them. He testified that his landscaping and cleaning activities each Tuesday and Friday also took two hours or more, depending on the season. He followed this set routine, week after week, without taking any vacations.

In addition to their testimony, the couple also provided receipts verifying the time spent on administrative work. Because each of the tenants paid rent on a different day, as soon as Bill received the rent he would take it to the bank to deposit it and then return home and input the transaction in his computer records. He testified that each of these trips took him about an hour. They also provided records establishing that Bill spent time each year, generating various items of correspondence with the tenants, including initiating an unlawful detainer action.

They also produced records regarding specific repairs that were made, establishing that these occasions arose eight times during the years in question. Additionally, Bill testified that he personally prepared a vacant four-bedroom unit for rental by scrubbing the walls, cleaning the unit, and facilitating the purchase and installation of new carpet.

The IRS contended that Bill's estimate, of the time it took for him to perform these activities, was overstated and that it was highly unusual for the owner of a single property to spend so much time on these activities. The court agreed that the IRS's contentions could be accurate for most individuals, but pointed out that Bill was in his sixties and was a 60% disabled veteran.

On the basis of Bill's established weekly routine, the court calculated that he had documented 12.5 hours a week devoted to the triplex, or 650 hours for the year. Adding in 36 hours each year for the 3 hours each month that he

spent depositing the rent checks and the additional hours spent on repair facilitation, tenant correspondence, and the other tasks, it was clear that Bill easily spent more than the required 750 hours performing services each year. Therefore, he materially participated, was a real estate professional, and the Lewises' rental activity for the years in issue was not passive for the purpose of section Code section 469.

A comparison of the results in the Flores and Lewis cases reveals how important it is for the taxpayer to document their activities. Often taxpayers have an inflated sense of the time they spend on rental activities and feel that a "ballpark" estimate will suffice. The Tax Court has ruled time and again that such guesstimates will not establish material participation. Furthermore, testimony alone will seldom be sufficient; the taxpayer needs to maintain some type of documentation to corroborate their assertions.

GLOSSARY

Glossary

Adequate	Reasonably sufficient or suitable.
Business expenses	Any expenses incurred in the ordinary course of business. Business expenses are deductible and are always netted against business income.
Contemporaneous	Existing or occurring in the same period of time.
Corroboration	Evidence that confirms or supports a statement, theory, or finding; confirmation.
Deductions	Any item or expenditure subtracted from gross income to reduce the amount of income subject to tax.
Expenditure	An amount of money spent.
Standard mileage rate	A set rate the IRS allows for each mile driven by the taxpayer for business, charitable, medical or moving purposes. The standard mileage rate can be taken in lieu of actual expenses incurred when calculating deductible automobile expenses related to any of the four activities above.
Substantiate	To establish by proof or competent evidence.