

TAX STRINGER

IN CASE YOU MISSED IT – May 2023

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Almost every day, federal and state courts issue opinions that affect taxpayers. The IRS and state taxing authorities also publish guidance on myriad topics.

Each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the author.

[Joseph Amundsen v. Commissioner](#) – Sloppy CPA liable for accuracy-related penalties.

This column often focuses on the substantiation requirements for claiming deductions, including the more rigorous substantiation requirements that exist for certain types of expenditures. CPAs often advise their clients on how to properly document their expenses in order to satisfy the substantiation requirements. In this case, it was a CPA who failed to substantiate his own expenses. One can only hope that the advice he gave his clients was better.

The taxpayer in the case was a CPA living in Pennsylvania who made frequent business trips to New York and New Jersey as part of his practice. On his 2017 tax return, the taxpayer claimed \$52,110 of deductions under the single line item of “cost of goods sold” on his Schedule C. Included within this amount were amounts expended on rent, home office, office supplies, meals, travel, entertainment, and licenses.

In 2018, the IRS issued the taxpayer a Notice of Deficiency disallowing the \$52,110 deduction for lack of substantiation, resulting in a proposed deficiency of \$12,786 for the 2017 tax year. In addition, the IRS assessed an accuracy-related penalty under [Code Sec. 6662\(a\)](#) of \$2,557. The taxpayer challenged the IRS determination in the Tax Court, representing himself pro se.

The IRS’ determinations of tax liability are presumed correct, and the taxpayer bears the burden of proving otherwise. Although [Code Sec. 7491](#) provides a mechanism that allows the taxpayer to shift the burden of proof to the IRS, the taxpayer must first satisfy the burden. Deductions are a “matter of legislative grace,” so taxpayers claiming a deduction must prove they are entitled to do so by

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identifying a statutory provision allowing the deduction and adequately substantiating that the expense has actually been paid or incurred. [Code Sec. 162\(a\)](#) broadly allows a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business, so the taxpayer easily pointed to a statutory provision allowing the claimed deductions. The issue for the court to decide, therefore, was whether the deductions were properly substantiated.

Taxpayers generally must keep and produce adequate records to substantiate expenses claimed as deductions to lower their tax liability. The adequacy of records could be determined by IRS rules and regulations. [Code Sec. 6001](#). The court sometimes estimates the amount of a deduction to which taxpayers have proved they are entitled, but first there must be “sufficient evidence” in the record to prove the deductible expense was paid or incurred. Furthermore, the court will not override the more stringent requirements for deducting certain specific expenses under [Code Sec. 274\(d\)](#).

Code Sec. 274(d) contains statutorily heightened substantiation requirements for certain expenses, including travel expenses (i.e., meals and lodging while away from home), expenses for gifts, and deductions with respect to certain “listed property” in [Code Sec. 280F\(d\)\(4\)](#) (company cars and other property generally used for entertainment or recreation). The Code Sec. 274(d) substantiation requirements for travel expenses are detailed in [Temporary Treasury Regulation § 1.274-5T](#). In general, a taxpayer is required to keep adequate records of: 1) the amount of each expense; 2) the dates that the taxpayer departed and returned and the number of days spent on business; 3) the destination of the travel; and 4) the business purpose for the travel. *Temp. Treas. Reg. § 1.274-5T(b)(2)*. To meet the “adequate records” requirement, 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.” *Temp. Treas. Reg. § 1.274-5T(c)(2)*.

The taxpayer in this case flooded the court with evidence that he claimed would substantiate his deductions, providing more than 200 pages of documents to support these expenses. However, most of the documents were self-created, including a profit-and-loss statement, revenue and expenses statement, general ledger with entries for personal and business expenses, and a tax diary chronicling the taxpayer’s business travels. He included canceled checks and bank statements from a checking account that was used for both personal and business expenses, but no third-party receipts to support the expenses listed in the documents he had created. The court held that the “voluminous general ledger” that included headings under which various expenses were categorized provided “little to no clarity as to the expenses themselves.” The court declined to sort through each piece of evidence to find support for the expenses the taxpayer was trying to claim, so it only allowed a general Code Sec. 162(a) deduction for certain business expenses that were “clearly” substantiated by the taxpayer’s checking account records. Ultimately, this covered only three expenses related to licensing and software that amounted to the relatively modest sum of \$1,915, merely a fraction of the total deductions the taxpayer was attempting to claim.

In addition, the taxpayer claimed several thousands of dollars in travel expenses that were subject to the heightened substantiation requirements of Code Sec. 274(d); he offered a “tax diary” as proof of these travel expenses. However, the tax diary only contained “vague names without any indication of who these people are or how they relate to petitioner's accounting practice” and a “per diem” entry for \$50 of each day of travel. Accordingly, the tax diary did not meet the regulatory requirement that

records of travel expenses include a description of the time, place, and business purpose of any travel. *Temp. Treas. Reg. § 1.274-5T(b)(2)*. Although a taxpayer may be allowed to deduct a per diem amount rather than including the amount of each specific expense for business travel under [Rev. Proc. 2011-47](#), in order to do so, the taxpayer must still keep records of the time, place, and business purpose of the travel for the relevant per diem rate deduction is sought. In this case, the taxpayer failed to meet even these minimum substantiation requirements and so was not entitled to deduct any amount for travel expenses, whether determined on a per diem basis or otherwise.

Also included in the lump-sum cost of goods sold deduction was approximately \$13,519 related to business use of the home. [Code Sec. 280A\(c\)](#) allows a taxpayer to deduct certain home office expenses only if certain requirements are met. A deduction may be allowed if a portion of the residence is “exclusively used on a regular basis” as the “principal place of business” for a trade or business of the taxpayer. The taxpayer claimed to use four of the ten rooms in his home “solely and exclusively for his [accounting] business.” However, the taxpayer did not provide any evidence to substantiate this claim, which the court indicated was far-fetched. Furthermore, the taxpayer attempted to deduct rent expenses in connection with a New York City office space and membership dues at the Yale Club. The court noted that these attempted rent deductions were further evidence that the taxpayer’s home was not his principal place of business. To make matters worse, the taxpayer did not provide evidence to establish why the rent expenses and membership dues were related to his accounting practice, so even these deductions were disallowed as not incurred in his trade or business.

The court’s analysis of the taxpayer’s deductions ended with a finding that less than \$2,000 in claimed expenses was properly deductible. The disallowed deductions resulted in a “substantial understatement of income tax,” subjecting the taxpayer to an accuracy-related penalty of 20% of the portion of the underpayment of tax under Code Sec. 6662.

As often discussed in this column, the accuracy-related penalty under § 6662 can be avoided if the taxpayer can show that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. [Code Sec. 6664\(c\)\(1\)](#). Whether there was reasonable cause and good faith depends on the facts and circumstances of the case. Included in that consideration is “the taxpayer’s efforts to assess the proper tax liability and the taxpayer’s knowledge, experience, and education.” The fact that the taxpayer was a practicing CPA who was “in the business of preparing tax returns, including Forms 1040 and Schedules C,” weighed heavily against a finding of reasonable cause and good faith. The taxpayer did not present evidence of any mitigating factors of reasonable cause and good faith, so he was properly assessed the accuracy-related penalty of 20% of the underpayment, resulting in an addition to his liability of \$2,557.

The taxpayer’s mistakes in this case were numerous. To start, instead of deducting expenses in the proper categories on his Schedule C, he simply erroneously tried to lump all of his expenses into the “cost of goods sold” line. Even after fixing this mistake by disaggregating the amount into their separate categories, he attempted to substantiate the expenses by simply dumping a copious number of documents on the court without spending the time and effort needed to explain what they represented or to break them down between the various expenses. Nevertheless, he still would have failed to substantiate his travel expenses as he did not maintain adequate contemporaneous records, a requirement that every accountant should know. In the end, the court found that there was no

excuse for an experienced CPA to make such basic mistakes and upheld the imposition of an accuracy-related penalty.

Takeaway: The taxpayer bears the burden to substantiate any expense for which the taxpayer claims a deduction. Certain expenses, including travel expenses, are subject to heightened substantiation requirements. Failure to properly substantiate is an easy win for the IRS. CPAs and other tax professionals who fail in this area on their own personal returns should expect to be subject to penalties and to receive little sympathy from the courts.

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