IN CASE YOU MISSED IT – February 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.

Happy New Year! As the new tax year begins, it is important for taxpayers and their advisers to remember to keep good records of all potentially deductible expenses. The following cases demonstrate instances in which the failure of a taxpayer to properly document transactions led to an increased tax liability.

Simpson – Failure to follow organizational formalities of S Corporation and lower-tier LLC led to deficiency and penalties.

Taxpayers (husband and wife) were equal shareholders in a wholly owned S corporation called Getify. The husband was also an employee of Getify. Getify maintained its own corporate checking account, savings account, and two credit cards. Getify also served as the registered agent and operating manager of Co-Working, a Texas LLC. For the tax years of 2011, 2012, and 2013, Getify claimed various deductions on its Form 1120-S for expenses such as telephone, auto and truck, and travel. In addition, for 2011 and 2012, Getify claimed substantial deductions for losses incurred on its investment in Co-Working. However, many of these outlays, including the alleged contributions made to Co-Working, were not paid out of Getify's accounts; instead, they were paid directly by Taxpayers on behalf of the corporation.

In 2012, the IRS began an investigation of the tax preparer that prepared and filed Taxpayers' returns for the relevant years. The investigation included an examination of the corporate returns of Getify and the individual returns of Taxpayers. In 2016, the IRS issued notices of deficiency covering Taxpayers' returns for 2011, 2012, and 2013, asserting income tax deficiencies,

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accuracy-related penalties, and failure-to-timely-file additions to tax of nearly $70,000 for the three years at issue.

The deficiencies were largely based on the deductions that Getify had taken for expenses that had been paid out of Taxpayers' personal accounts. The IRS alleged that these payments should be classified as unreimbursed employee expenses rather than expenses of Getify, and deductible to Taxpayers as miscellaneous deductions to the extent that they were substantiated. However, the IRS also alleged that certain expenses were not properly substantiated.

In many circumstances, a shareholder may voluntarily pay business expenses on behalf of a corporation in an attempt to protect his equity investment; thus, the expenses are treated as a contribution to the capital of the corporation followed by the corporation's payment of the expense. If Taxpayers in this case were only shareholders and not also employees, that might have been the proper treatment. However, the characterization of expenses paid by employees requires an additional layer of analysis because "being an employee constitutes a trade or business in and of itself." When shareholders of a corporation are also employees, as was the case here, it must be determined if the expenses were capital in nature, i.e., whether they were incurred to protect the shareholder-employees' equity interest, or whether they were incurred as ordinary and necessary expenses associated with the shareholders' status as employees. (Interestingly, the Court gave little consideration to the question of whether it was possible for the expenses to be characterized as expenses of the corporation rather than of the shareholder/employee.)

The Court explained that a capital expenditure "(1) creates or enhances a separate and distinct asset, (2) produces a significant future benefit, or (3) is incurred 'in connection with' the acquisition of a capital asset such that it is directly related to the acquisition." The expenses in dispute in this case were expenses paid by Taxpayers for auto and truck, travel, meals, accounting, telephone and internet, and business use of the home. Taxpayers did not even attempt to provide support for the idea that these expenses were incurred to acquire or create a capital asset or to produce a significant future benefit. The Court held that the expenses were properly characterized as ordinary expenses that were merely incidental to the business and were incurred in connection with Taxpayer husband's carrying on of a trade or business as an employee of Getify; therefore, these should be treated as ordinary and necessary employee expenses.

As employee expenses, the Court then had to determine whether Getify and taxpayers had a reimbursement arrangement that would qualify as an "accountable plan" under Code Sec. 62 and Treas. Reg. 1.62-2. When an employer reimburses an employee in accordance with an accountable plan, the amounts paid to the employee are excluded from his or her income [/]. A reimbursement arrangement is an accountable plan if it allows for the reimbursement of deductible business expenses, requires employees to properly substantiate all expenses, and requires employees to return reimbursed amounts in excess of substantiated expenses. If a reimbursement arrangement does not meet these requirements, it is a "nonaccountable plan," and amounts paid under the plan are included in the employee's income and the expenses paid for by the employee are only deductible as miscellaneous itemized deductions under Code Sec. 67 on Schedule A of the employee's Form 1040 [Treas. Reg. 1.62-2(c)(5)].

Taxpayers argued in this case that the expenses they had incurred had been reimbursed under an accountable plan. If that was the case, the amounts which they received from Getify as reimbursement for these expenses would be excluded from their income. Unfortunately, there was no evidence that any plan existed. The Court noted that while reimbursement arrangements are not required to be in written form, “there must be, at the very least, *some* extrinsic evidence that indicates that such a plan exists.” Taxpayers and their accountant testified that they had discussed implementing an accountable plan, but that there was “no formal thing.” Furthermore, Taxpayers presented no evidence that they were required to substantiate expenses or return excess amounts; in fact, the Court noted a severe lack of recordkeeping. Taxpayers did not properly document expenses and there were no records at all to explain many of the transfers from the corporate account to Taxpayers’ personal accounts; thus, there was no way to know if they should have been characterized as reimbursements or as distributions.

Because there was no accountable plan, the expenses claimed as corporate deductions were treated by the Court as unreimbursed employee expenses which would be deductible by Taxpayers (not Getify) only as miscellaneous itemized deductions under Code Sec. 67. For the tax years at issue, Code Sec. 67 contained a limitation that miscellaneous itemized deductions were only deductible to the extent that in the aggregate, they exceeded 2% of adjusted gross income (for tax years 2018–2025, the miscellaneous itemized deduction is entirely disallowed). To make matters worse, many of Taxpayers’ deductions were not fully substantiated, further limiting the amount of any deduction.

In addition, Getify, as a member of Co-Working LLC, had tried to claim substantial losses in taxable years 2011 and 2012 on the failed business. These losses were disallowed by the Court because Taxpayers had failed to keep proper records of their basis in the LLC. Taxpayers claimed that they had made contributions to the LLC on behalf of Getify in checks and in cash, which would have increased their basis. They also claimed that other partners in Getify had gifted interests in the LLC to Getify, which would have further increased their basis to the extent of the carried- over basis from the donors.

The Court did not find Taxpayers’ assertions about contributions to Getify and the gifted interests to be reliable. Taxpayers provided very little documentary evidence to support these assertions and claimed that they did not have access to the information. The Court found this lack of evidence especially problematic given that Texas law would have required the LLC to keep a continuously updated list of the ownership percentage of its various members as well as a detailed record of all contributions. Texas law also would have given each member of the LLC the ability to examine the books and records of the LLC, which presumably would have given Taxpayers the ability to obtain bank records and other evidence that would have helped their case. Because Taxpayers did not provide evidence which should have been “readily accessible” to them under Texas law, the Court presumed that if such evidence was produced, it would have been unfavorable to Taxpayers. As such, the vast majority of claimed losses in Co-Working LLC were disallowed.

Takeaway: The importance of maintaining proper documentation cannot be emphasized enough, whether they be trade or business expenses paid directly by the corporation or as reimbursable expenses of the employee, as well as keeping track of basis in investment entities for future calculation of gain or loss.

Vassiliades – "Extraordinary" circumstances did not justify failure to substantiate education expenses.

Taxpayer in this case had claimed an American Opportunity Credit (AOC) for tuition expenses paid for his daughter's education at University College London (UCL). Because UCL was in the U.K., Taxpayer would wire money to a British bank account that his daughter would then use to pay tuition. During 2018, Taxpayer wired nearly $6,000 to his daughter, presumably for this purpose. Based on this amount, Taxpayer claimed the full $2,500 AOC for tax year 2018.

In September 2020, the IRS issued Taxpayer a notice of deficiency for tax year 2018 denying the $2,500 AOC on the basis that Taxpayer had not substantiated that he had paid qualified education expenses. Although there was evidence that Taxpayer had made payments to his daughter, the only receipt provided from UCL for the payment of tuition was from 2017, and that receipt reflected a payment made not by Taxpayer but by the mother of Taxpayer's daughter, who was not a party to the proceeding. (Presumably as a non-U.S. institution, UCL was not required to provide Form 1098-T: Tuition Statement.) Taxpayer claimed that part of the reason he was unable to substantiate the tuition expenses was because his home had been burglarized in November 2018, resulting in the theft of "various important documents." He did not testify which documentation he might have had prior to the burglary that allegedly supported the deduction.

The Court wrote: "While we are sympathetic to petitioners' loss and difficulty in procuring documents, from the record before us we are unable to conclude that petitioners paid qualified tuition and related expenses to UCL." The Court was skeptical that Taxpayer and his daughter could not procure substantiation from UCL. Taxpayer was therefore denied the full amount of the AOC for 2018.

Takeaway: The substantiation requirements of the Code are very difficult to overcome, even in the most sympathetic situation. In an electronic environment, however, it is becoming much easier to obtain duplicate copies of invoices and proof of payment. As shown in both of these cases, if adequate substantiation is not produced, Courts will infer that it either does not exist, or that it will in fact harm the taxpayer's position.

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