

## Substantiating Business Deductions with the IRS

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### What documentation do contractors need to substantiate business deductions with the IRS? And what are the potential costs of noncompliance?

Most contractors do not enjoy receiving IRS correspondence requesting information. This type of request usually provides an individual with an anxious and uneasy feeling at best. Possessing the proper documentation to sustain the business deduction helps to assuage those feelings. More importantly, proper documentation provides the necessary ammunition to prevent the IRS from assessing additional amounts.

Everyone subject to income tax must keep permanent books of account or records, including inventories sufficient to establish the amount of gross income, deductions, credits, and other items shown on the income tax return.<sup>1</sup> An otherwise deductible expense will not qualify for deduction unless the taxpayer is able to substantiate the expense.<sup>2</sup> As the taxpayer (and not the IRS) has the burden of proving the claimed amounts are correct, it is essential that the taxpayer is able to provide this proof.<sup>3</sup> All transactions that could result in gross income, deductions, credits, or other items that must be shown on the taxpayer's tax return are subject to this substantiation obligation.<sup>4</sup> There are no exceptions.<sup>5</sup> If the taxpayer is not sure if a particular transaction will eventually impact the taxable income of its business, it behooves the taxpayer to keep the necessary records of the transaction in case it eventually does.

Substantiation of a taxpayer's business deduction consists of possessing proof of the amount of the payment and providing evidence establishing the character of the expense (e.g., business, personal, capital, charitable, etc.).<sup>6</sup> Please note that the substantiation requirements for charitable contributions are beyond the scope of this article and will not be addressed.

### Proof of payment

The IRS provided a roadmap of what it will accept as proof of payment in Revenue Procedure 92-71. The Revenue Procedure provides that a canceled check is proof of payment of an amount.<sup>7</sup> The Revenue Procedure also indicates that the IRS will accept as proof of payment account statements "prepared by a financial institution that show a check clearance (i.e., a decrease to the account holder's balance) if the statement shows:

1. the check number,
2. the amount of the check,
3. the date the check amount was posted to the account by the financial institution, and
4. the name of the payee."<sup>8</sup>

"An account statement prepared by a financial institution showing an electronic funds transfer (i.e., a decrease to the account holder's balance) will be accepted as proof of payment if the statement shows:

1. the amount of the transfer,
2. the date the transfer was posted to the account by the financial institution, and
3. the name of the payee."<sup>9</sup>

As the taxpayer (and not the IRS) has the burden of proving the claimed amounts are correct, it is essential that the taxpayer is able to provide this proof.

“An account statement prepared by a financial institution showing a credit card charge (i.e., an increase to the cardholder’s “loan” balance) will be accepted as proof of payment if the statement shows:

1. the amount of the charge,
2. the date of the charge by the cardholder (i.e., the transaction date), and
3. the name of the payee.”<sup>10</sup>

“For a taxpayer that cannot prove payment of an amount by providing a canceled check or an account statement, the Service will generally require other evidence of payment of an amount. For example, the combination of an invoice marked ‘paid,’ a check register or carbon copy of the check, AND an account statement that shows the check number, date, and amount generally will prove payment of an amount.”<sup>11</sup>

The Tax Court has granted taxpayers partial deductions where taxpayers lacked the requisite records but provided credible testimony and evidence of the expense.<sup>12</sup> However, if insufficient evidence to make an estimate is presented to the court by the taxpayer, the taxpayer’s claimed deduction will not be upheld.<sup>13</sup> Note, this so-called “Cohan” rule that may be used by a court to estimate business expenses does not apply to the §274(d) expenses discussed below.

Contemporaneous, legible documentary evidence and third-party verification tend to provide the strongest support for the existence and the amount of an expenditure and should be obtained and retained whenever possible.<sup>14</sup> It is always more time-consuming and expensive to recreate history than to merely recite it.

## **Establishing the character of the expenditure and the I.R.C. §274(d) strict substantiation requirements**

As stated previously, proof of payment of an amount alone does not establish that a taxpayer is entitled to a tax deduction.<sup>15</sup> A taxpayer should also keep any other documents that may help to establish the character of the expense and the entitlement of the taxpayer to a tax deduction.<sup>16</sup> Examples of items to retain to provide evidence establishing the character and deductibility of the expense are receipts, sales slips, charge slips, payment acknowledgments, signed invoices, check registers, and carbon copies of checks.<sup>17</sup>

The discussion so far has related to the substantiation of business expenses in general. However, in I.R.C. §274(d) the IRS has identified certain categories of expenses (§274(d) expenses) subject to potential abuse. As such, the IRS has stricter substantiation requirements with respect to these §274(d) expenses.<sup>18</sup> The §274(d) strict substantiation requirements apply to deductions claimed for traveling expenses, entertainment items, business gifts, and expenses with respect to §280F(d)(4) listed property (e.g., automobile expenses).<sup>19</sup> The §274(d) strict substantiation requirements also apply to “Accountable Plan” reimbursements to employees (discussed later) for §274(d) expenses.<sup>20</sup>

An entertainment item is any item “with respect to an activity of a type generally considered to constitute entertainment, amusement, or recreation” or any item “with respect to a facility used in connection with” an entertainment activity.<sup>21</sup> Examples include entertaining customers or clients at “nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips.”<sup>22</sup> It also may include “meeting personal, living, or family needs of individuals, such as providing meals, a hotel suite, or a car to customers or their families”.<sup>23</sup>

In general, §280F(d)(4) listed property is

1. “any passenger automobile,
2. any other property used as a means of transportation,
3. any property of a type generally used for purposes of entertainment, recreation, or amusement,
4. any computer or peripheral equipment (except computers used exclusively at a regular business establishment and owned or leased by the person operating such establishment), and
5. any other property of a type specified in IRS regulations”.<sup>24</sup>

### Adequate records

If a deduction is one to which the §274(d) strict substantiation requirements apply, the deduction is not allowed unless, in addition to the other requirements for deductibility, the taxpayer establishes certain information by “adequate records or by sufficient evidence corroborating the taxpayer’s own statement”.<sup>25</sup> To meet the “adequate records” requirements of §274 (d), a taxpayer shall maintain records and documentary evidence sufficient to establish each of the following elements of an expenditure:

1. the amount of the item,
2. the time and place the expense occurred,
3. the business purpose of the item, and
4. the business relationship to the taxpayer of the recipient of the entertainment item.<sup>26</sup>

To assist taxpayers with the income tax return reporting requirements relating to these items, the IRS has issued Publication 463, Travel, Entertainment, Gift, and Car Expenses. In Publication 463, the IRS provided a matrix that is helpful in determining what constitutes the “adequate records” that must be kept to prove these business expenses. A copy of the matrix is included here as Exhibit 1. It is clear that the IRS intends that the taxpayer keep a diary, account book, trip sheet, log, or similar record of these types of expenses.<sup>27</sup> In addition, the records required to be kept should be prepared while “the taxpayer has full present knowledge of the elements of the expenditure”.<sup>28</sup> The Tax Court has disallowed a deduction when the record relied upon by the taxpayer was prepared three to four years after the expenditure was made.<sup>29</sup>

Keeping a record of this information is not adequate substantiation in all circumstances.<sup>30</sup> Documentary evidence (such as receipts, canceled checks, or bills) is also still generally required to sustain the deduction.<sup>31</sup> There is a \$75 de minimis exception for these expenses (except for lodging).<sup>32</sup> So, if an expense is less than \$75 (and does not relate to lodging), documentary evidence is not required to be retained so long as the diary contemplated by Treas. Reg. §1.274-5T (c)(2)(i) discussed above is retained.<sup>33</sup>

The IRS has also attempted to alleviate the burden of establishing the amount of deductible automobile, lodging, meal, and incidental travel expenses through the use of various “deemed substantiation” methods (e.g., standard mileage rates, mileage allowances, fixed and variable rate payments, per diem and high-low method allowances, etc.).<sup>34</sup> Though this may eliminate the need to obtain documentary evidence of the amount of the expense, records will still need to be kept establishing the elements of time, place, and business purpose of the expenses.<sup>35</sup> It should be noted that the IRS will exempt some “nonpersonal use” vehicles from the strict substantiation requirements of §274(d) but rigid guidelines must be followed to avoid the substantiation requirements.<sup>36</sup>

Some examples of qualified nonpersonal use vehicles not subject to the §274(d) strict substantiation requirements are cement mixers, cranes and derricks, dump trucks, flatbed trucks, any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds, and forklifts.<sup>37</sup> To ensure the proper records are kept, a taxpayer should confirm the nonpersonal use nature of a vehicle with its tax advisor upon the purchase of the vehicle.

Simplified substantiation requirements for telecommunications equipment such as sampling techniques are being considered by the IRS.<sup>38</sup> However, as of the date this article was authored, these techniques were not approved by the IRS.<sup>39</sup>

### **Substantiation by other sufficient evidence**

If “adequate records” are not kept, then “other sufficient evidence” corroborating the taxpayer’s own statement will be required to sustain the deduction.<sup>40</sup>

Establishing the required level of proof in these cases is usually very difficult and this method of substantiation is generally not looked upon favorably by the courts.<sup>41</sup> As a result, this method of substantiation will usually be chosen by the taxpayer only for very large items for which “adequate records” do not exist.

Supporting evidence must be either direct evidence or documentary evidence.<sup>42</sup> However, circumstantial evidence, instead of direct evidence, will be allowed if the element of the expense being substantiated is the business relationship of your guests or the business purpose of the amount spent.<sup>43 44</sup> Direct evidence can be written statements or the oral testimony of guests or other witnesses setting forth detailed information about the element of the expense.<sup>45</sup> Examples of documentary evidence are receipts, paid bills, or similar evidence but they must contain detail equivalent to the detail required in the “adequate records” provision.<sup>46</sup>

Estimating §274(d) expenses is not allowed by the IRS (i.e., the “Cohan” rule does not apply to §274(d) expenses).<sup>47</sup> However, the IRS will allow sampling if adequate records are kept for a portion of the year and the taxpayer can demonstrate by other evidence (such as invoices and bills) that the periods for which an adequate record is kept are representative of the use throughout the tax year.<sup>48</sup>

Some leniency may also be available in exceptional circumstances or if records have been destroyed due to fire, flood, and other casualty.<sup>49</sup> In such situations, it may be impossible to obtain a receipt. However, other evidence that is the “best proof possible under the circumstances” or a “reasonable reconstruction of his expenditures or use” will need to be provided.<sup>50</sup>

The less that is left to interpretation and/or to IRS leniency/discretion, the more likely the deduction will be allowed. The IRS is focusing on these expenses as items of abuse and has taken a particularly adversarial stance to taxpayers in this area. Given the attitude of the IRS and the difficulty and expense involved providing “sufficient evidence,” it would be prudent to keep “adequate records” if at all possible.

### **Notable situations where I.R.C. §274(d) strict substantiation requirements are not applicable**

Otherwise deductible “expenses related to providing food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for the taxpayer’s employees” are 100 percent deductible under §274(e)(1).<sup>51</sup> Therefore, the §274(d) strict substantiation requirements do not apply to these types of expenses.<sup>52</sup>

Otherwise deductible expenses relating to “recreational, social, or similar activities” for employees (e.g., holiday parties, summer outings, etc.) are fully deductible under §274(e)(4).<sup>53</sup> Therefore, the §274(d) strict substantiation requirements do not apply.<sup>54</sup> However, the “taxpayer shall keep such records or other evidence as shall establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners, or highly compensated employees.”<sup>55</sup>

### Substantiation required for reimbursements to employees under accountable plans

If an employer reimburses an employee for business-related expenses the payments generally must be treated as taxable wages subject to withholding and payment of employment taxes (e.g., Federal Insurance Contributions Act (FICA) taxes and Federal Unemployment Tax Act (FUTA) taxes) unless they are made under an “accountable plan”.<sup>56</sup> If the employer reimbursements are treated as paid under an accountable plan, they are deductible by the employer, excluded from the employee’s gross income, are not reported as wages or other compensation on the employee’s Form W-2, and are exempt from the withholding and payment of employment taxes.<sup>57</sup> Accountable plan substantiation requirements are as follows:

1. To the extent an employee is reimbursed under an accountable plan for §274(d) business expenses, the strict substantiation requirements for §274(d) apply.<sup>58</sup> The employee must submit to the payor information sufficient to meet the strict substantiation §274(d) requirements within a “reasonable period of time” (discussed below).<sup>59</sup>
2. For accountable plan employee reimbursements of business expenses not covered by the strict substantiation requirements of §274(d) discussed above, the employee must submit to the payor information “sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the employer’s business activities”.<sup>60</sup> This submission must be done within a “reasonable period of time” (discussed below).<sup>61</sup>
3. A “reasonable period of time” depends on the facts and circumstances of each case.<sup>62</sup> However, under a safe-harbor rule, an expense adequately accounted for within 60 days after it was paid or incurred will be treated as having occurred within a reasonable period of time.<sup>63</sup> To avoid an IRS interpretation of what is a “reasonable period of time,” the safe-harbor rule should be followed if possible.

The IRS has provided a matrix of reporting requirements relating to employer reimbursements in Publication 463. It is reproduced as Exhibit 2.

### Don’t want to play by the rules? Get ready to pay

If the substantiation requirements are not met for deductions claimed relating to amounts paid or due to nonshareholder employees or third parties, the IRS may:

1. completely disallow the amount claimed as a deduction, subjecting the taxpayer to additional income tax as well as penalties and interest (discussed below).
2. rule that all payments to nonshareholder employees made under a reimbursement arrangement are taxable wages to the nonshareholder employees.<sup>64</sup> If the IRS makes this kind of determination, the employee may be forced to retroactively pay income tax (and interest) on the reimbursement as well as FICA taxes. This will substantially damage the goodwill the employer has with its employees. In addition, the IRS may seek to penalize the employer for its failure to withhold payroll taxes on the payment.<sup>65</sup>

Woe to the taxpayer in either of these situations. The IRS has numerous late filing and payment penalties in its arsenal. Among them include:

1. Late income and payroll tax filing and late payment penalties of up to 47.5 percent of the additional tax being assessed (assuming no fraud was involved).<sup>66</sup>
2. Failure to deposit a required tax with an authorized government depository penalty of up to 15 percent of the amount not timely deposited.<sup>67</sup>
3. A penalty of up to \$250,000 (\$50/return) per calendar year for failure to supply the IRS with information returns.<sup>68</sup> If the filer intentionally disregards the reporting rules, the \$250,000 cap does not apply.<sup>69</sup>

The various state taxing authorities will be looking to assess penalties as well.

If the substantiation requirements are not met for deductions claimed relating to amounts paid or due to a shareholder or other owner of the employer, the IRS will likely treat the payment as a nondeductible distribution of profits.<sup>70</sup> In addition to increasing the taxable income of the business and potentially subjecting the business to the penalties discussed above, the owner may need to report additional taxable income. Any resulting additional tax on this income may be subject to the late payment interest and other applicable penalties discussed above. Another potentially devastating effect could be an unintended termination of the employer's S Corporation election and loss of pass-through entity status as a result of failing the "one class of stock" requirement (due to disproportionate distributions to shareholders) for S Corporations.

## Conclusion

As you can see, the potential costs of not possessing the requisite substantiation for business deductions are particularly prohibitive and are potentially fatal to a business. To avoid bearing the burden of these costs, it is essential for a taxpayer to possess the requisite substantiation as the IRS has taken a particularly combative stance against taxpayers in this area.

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## NOTES

<sup>1</sup>I.R.C. § 6001; Treas. Reg. § 1.6001-1(a).

<sup>2</sup>See *Lillis v. Comr.*, T.C. Memo. 1983-142, aff'd by unpub. opin. (9th Cir. 1984).

<sup>3</sup>See *Harrell v. Tomlinson*, 63-1 USTC § 9120, p.87, 149 (citing *Welch v. Helvering*, 290 U.S. 111 (1933)).

<sup>4</sup>I.R.C. § 6001; Treas. Reg. § 1.6001-1(a).

<sup>5</sup>See *Delaney v. Comr.*, T.C. Memo. 1982-666, aff'd 743 F.2d 670 (9th Cir. 1984).

<sup>6</sup>I.R.C. § 6001, Treas. Reg. § 1.6001-1(a); Rev. Proc. 92-71, 1992-2 CB 437.

<sup>7</sup>Rev. Proc. 92-71, 1992-2 CB 437.

<sup>8</sup>Id.

<sup>9</sup>Id.

<sup>10</sup>Id.

<sup>11</sup>Id.

<sup>12</sup>See *Cohan v. Comr.*, 39 F.2d 540 (2d Cir. 1930).

<sup>13</sup>See *Williams v. U.S.*, 245 F.2d 559 (5th Cir. 1957).

<sup>14</sup>Treas. Reg. § 1.274-5T(c)(2)(ii)(A); Rev. Proc. 92-71, 1992-2 CB 437.

<sup>15</sup>1.R.C. § 6001; Treas. Reg. § 1.6001-1(a); Rev. Proc. 92-71, 1992-2 CB 437.

<sup>16</sup>Id.

<sup>17</sup>Rev. Proc. 92-71, 1992-2 CB 437.

<sup>18</sup>Id.

<sup>19</sup>Id.

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<sup>20</sup>d.

<sup>21</sup>I.R.C §§ 274(a)(1)(A) & (B).

<sup>22</sup>IRS Publication 463, 1/21/10.

<sup>23</sup>d.

<sup>24</sup>I.R.C. § 280F(d)(4)(A).

<sup>25</sup>I.R.C. § 274(d).

<sup>26</sup>Treas. Reg. § 1.274-5T(b); Treas. Reg. § 1.274-5T(c)(2)(i).

<sup>27</sup>Treas. Reg. § 1.274-5T(c)(2)(i).

<sup>28</sup>Treas. Reg. § 1.274-5T(c)(2)(ii)(A).

<sup>29</sup>See *Rembush v. Comr.*, T.C. Memo. 1979-73.

<sup>30</sup>Treas. Reg. § 1.274-5(c)(iii).

<sup>31</sup>d.

<sup>32</sup>d.

<sup>33</sup>See *Silverton v. Comr.*, T.C. Memo. 1978-22.

<sup>34</sup>See, e.g., Treas. Reg. § 1.274-5(j).

<sup>35</sup>Treas. Reg. § 1.274-5T(c)(2)(i).

<sup>36</sup>See, e.g., Treas. Reg. § 1.274-5T(k).

<sup>37</sup>d.

<sup>38</sup>Notice 2009-46, 2009-23 I.R.B. 1068.

<sup>39</sup>d.

<sup>40</sup>Treas. Reg. § 1.274-5T(c)(3)(i).

<sup>41</sup>See, e.g., *Reynolds v. Comr.*, 296 F.3d 607 (7th Cir. 2002), aff'g T.C. Memo. 2000-20.

<sup>42</sup>Treas. Reg. § 1.274-5T(c)(3)(i); IRS Publication 463, 1/21/10.

<sup>43</sup>Treas. Reg. § 1.274-5T(c)(3)(i).

<sup>44</sup>d.

<sup>45</sup>d.

<sup>46</sup>d.

<sup>47</sup>Treas. Reg. § 1.274-5(c)(2)(iii).

<sup>48</sup>Treas. Reg. § 1.274-5T(c)(3)(ii).

<sup>49</sup>Treas. Reg. §§ 1.274-5T(c)(4) & (5).

<sup>50</sup>d.

<sup>51</sup>I.R.C. § 274(e)(1).

<sup>52</sup>Treas. Reg. § 1.274-5T(c)(7)(i).

<sup>53</sup>I.R.C § 274(e)(4).

<sup>54</sup>Treas. Reg. § 1.274-5T(c)(7)(i).

<sup>55</sup>Treas. Reg. § 1.274-5T(c)(7)(ii).

<sup>56</sup>Treas. Reg. § 1.62-2(c)(5).

<sup>57</sup>Treas. Reg. § 1.62-2(c)(4).

<sup>58</sup>Treas. Reg. § 1.62-2(e)(2).

<sup>59</sup>Treas. Reg. § 1.62-2(e)(1); Treas. Reg. § 1.62-2(e)(2).

<sup>60</sup>Treas. Reg. § 1.62-2(e)(3).

<sup>61</sup>Treas. Reg. § 1.62-2(e)(1).

<sup>62</sup>Treas. Reg. § 1.62-2(g)(1).

<sup>63</sup>Treas. Reg. § 1.62-2(g)(2)(i).

<sup>64</sup>Rev. Rul. 2006-56, 2006-2 CB 874.

<sup>65</sup>See e.g., *Peoples Life Ins. Co. v. U.S.*, 373 F.2d 924 (Ct. Cl. 1967).

<sup>66</sup>I.R.C § 6651(c)(1).

<sup>67</sup>I.R.C. § 6656(b)(1).

<sup>68</sup>I.R.C. § 6721 (a)(1).

<sup>69</sup>I.R.C. § 6721 (e)(3).

<sup>70</sup>See *Silverman v. Comr.*, 253 F.2d 849 (8th Cir. 1958), aff'g 28 T.C. 1061 (1957); *Greenspon v. Comr.*, 229 F.2d 947 (8th Cir. 1956), aff'g 23 T.C. 138 (1954), acq., 1955-1 C.B. 4; *Challenge Mfg. Co. v. Comr.*, 37 T.C. 650 (1962), acq., 1962-2 C.B. 4.