THETAXBOOK News Release Date: 3/23/23

Income Statement Verified by a CPA is Not Substantiation

Cross References

- *Barrios,* T.C. Memo. 2023-32

For some types of expenses, lack of substantiation can be overcome. If a taxpayer establishes that a deductible expense has been paid but cannot establish the precise amount, the Court may estimate the amount under the so called *Cohan* rule. (*Cohan,* 2nd Circuit Court of Appeals, 1930).

In making the estimate, the Court bears heavily against the taxpayer who failed to more precisely substantiate the expense. The Court will not estimate a deductible expense unless the taxpayer presents a sufficient evidentiary basis on which an estimate can be made. A Court cannot just simply guess. No estimate can be made of expenses governed by the strict substantiation requirements of IRC section 274 (travel expenses, gifts, and vehicle expenses subject to the listed property rules).

If a taxpayer can establish that he once had adequate records but lost the records because of circumstances beyond his control, such as a fire, flood, or other casualty, then the Court will permit the taxpayer to reasonably reconstruct his expenses. Crucial to this reconstruction is that the secondary evidence be credible. If no other documentation is available, the Court may, but is not required to accept credible testimony of a taxpayer to substantiate an expense.

The taxpayer in this case did not file a 2011 tax return. The IRS accordingly prepared a substitute return based upon information received from third parties, and then issued a notice of deficiency. The taxpayer then petitioned the Tax Court. In 2018, while the case was pending, the taxpayer provided to the IRS a 2011 Form 1040 that was prepared by a certified public accountant (CPA).

On that return, the taxpayer reported adjusted gross income of negative $254,786 and indicated that he owed no tax for 2011. As relevant for this case, the Form 1040 reported $7,565,528 in gross business receipts, $6,266,451 for a cost of goods sold deduction, $1,257,618 for wages paid, $54,024 for insurance, $35,144 for depreciation, and $189,368 for assorted other expenses.

To substantiate his expenses, the taxpayer primarily relied on a reconstructed profit and loss statement that was verified by his CPA. The CPA testified that he supervised the preparation of the statement by discussing with the taxpayer's bookkeeper her general approach as to the inclusion and categorization of 2011 expenses and then spot-checking her work.

The Court noted that the profit and loss statement was not prepared in 2011 but rather was a reconstruction compiled in 2018 after this litigation had already begun. The taxpayer did not lose any underlying financial records from 2011 because of circumstances beyond his control. Thus, a reconstruction of this sort is not proper substantiation.

Moreover, the profit and loss statement merely contains a list of categories and amounts of expenses, without the introduction of any source documents underlying the figures. The taxpayer attempted to introduce source documents, but the Court rejected them as hearsay, as they were merely QuickBook reconstructions prepared in 2018 by a bookkeeper who had no direct knowledge of the 2011 expenses, and who apparently relied upon discussions with a previous bookkeeper. During the trial, the taxpayer's sole witness described the original bookkeeper as unqualified and error-prone.

The taxpayer also attempted to introduce payroll records from Paychex, Inc., but failed to offer the testimony of a records custodian or qualified witness who could explain the record keeping system of the organization. The CPA offered no explanation of that company's recordkeeping system.

The Court noted the CPA's "confidence that these expenses are substantially correct," is insufficient to substantiate the nature, amount, or purpose of the claimed deductions. A taxpayer's general statement that his or her expenses were incurred in pursuit of a trade or business is not sufficient to establish that the expenses had a reasonably direct relationship to any such trade or business.

As a final point, the profit and loss statement was inconsistent in several respects with the expense amounts reported on the 2011 Form 1040 that was provided to the IRS. These differences further undermine any confidence the Court might have in a reconstruction prepared seven years after the fact during litigation. The Court ruled the lack of documentary evidence combined with the non-compelling nature of the CPA's testimony means the taxpayer failed to meet his burden to substantiate his claimed business expenses in excess of the amounts previously allowed by the IRS.