



## IN CASE YOU MISSED IT – August 2021

*By Ellen S. Brody, JD, CPA, Esq.*

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.

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### [Nurumbi v. Commissioner](#) - the importance of proper substantiation

Petitioner was an Uber driver during 2015, providing transportation to passengers in exchange for variable fares. He allowed friends and family to sign up for Uber under his account, and then rented them his vehicles for their driving use. The other drivers accessed the Uber app to see records of their trips driven and fares collected, but all of their net fares were paid by Uber to petitioner into his bank account. Petitioner did not enter into any written contracts with the other drivers; he simply paid them their earnings as shown on the Uber weekly statements, routinely withholding \$250 as a vehicle rental charge for using his cars. He would also reimburse the drivers for gas, vehicle maintenance costs, and other miscellaneous expenses. Although some of these payments were made by electronic transfer from his bank account and were thus traceable, he claimed that other payments to the drivers were made by cash. Petitioner did not provide the drivers any documentation indicating the amount of payments they were receiving, and the drivers did not submit receipts or keep any logs for gas, vehicle maintenance, or other miscellaneous expenses.

Petitioner filed a tax return reporting wages of \$18,810. Upon audit, the Service issued a notice of deficiency, claiming that he had failed to report \$542,420 in gross receipts and \$755 in other income from Uber, resulting in a deficiency of \$193,784.

[Code section 61\(a\)](#) provides that gross income means “all income from whatever source derived.” The court found that it was clear from the record that petitioner earned income by driving for Uber and by having others drive for Uber under his account. The Service was able to easily establish the amount of petitioner's gross income through the Forms 1099-K and 1099-MISC that Uber issued to him, tying them to the direct deposits made by Uber into petitioner's bank account.

The main issue that the court had to decide was whether petitioner was entitled to more Schedule C deductions in connection with the Uber driving activity than the Service allowed. [Code section 162\(a\)](#) allows a

deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”

The question before the court was not whether the expenses claimed by petitioner were ordinary and necessary, as the Service conceded that point, but whether petitioner could satisfy the burden of proof of substantiating each claimed deduction through records he had maintained that would be deemed sufficient to establish the amount of the deduction. [Code section 6001](#). Although the [Cohan](#) case of 1930 set forth the rule allowing a court to estimate the amount of the expense if the taxpayer is able to demonstrate that he has paid or incurred a deductible expense but cannot substantiate the precise amount, this only applies when the taxpayer can otherwise produce credible evidence providing a basis upon which the court can make an estimate. Additionally, [Code section 274\(d\)](#) superseded this rule, requiring certain business expenses to satisfy heightened substantiation requirements, such that no deduction or credit shall be allowed on the basis of the taxpayer’s mere approximations or unsupported testimony, but rather requiring a taxpayer to provide either adequate records or sufficient other evidence to corroborate the taxpayer’s statements regarding the amount of the expense, the time and place of the travel or use, and the business purpose of the expense. Included in this rule are deductions related to property classified as listed property under [Code section 280F\(d\)\(4\)](#).

The definition of listed property in Code section 280F(d)(4)(A)(ii) includes property used as a means of transportation. Although there is an exception to this inclusion, it is only applicable for vehicles substantially all of the use of which is in a trade or business of providing to unrelated persons services consisting of the transportation of such persons or property for compensation or hire. Although this sounds exactly like petitioner’s situation, as his vehicles were used to transport persons for hire, he submitted no evidence that “substantially all of the use” of his vehicles was in connection with the Uber driving. Petitioner’s vehicles were SUVs or passenger trucks; he did not submit any evidence that he maintained a separate vehicle for the personal use of him or his wife. Therefore, his vehicles are considered to be listed property under Code section 280F(d)(4)(A)(ii), and he was required to satisfy the heightened substantiation requirements under Code section 274(d) and provide adequate records to support his claimed deductions.

Adequate records means an account book, log or similar record with the accompanying documentary evidence to establish each of these elements with respect to an expenditure [[Treasury regulation section 1.274-5T\(c\)\(2\)\(i\)](#)]. If adequate records do not exist, the taxpayer can satisfy the heightened substantiation requirement by providing an oral or written statement containing specific information on each required detail.

The court held that petitioner failed to meet the heightened substantiation requirement, as he failed to do the work necessary to separate personal expenses from business expenses and did not provide the underlying documents for those expenses. As he did not maintain sufficient records, he was not entitled to any additional deductions.

The Service had allowed petitioner a deduction for payments he made to his drivers for the amounts that they were able to trace from the weekly Uber direct deposits into his bank account to the funds he paid the drivers directly out of that bank account. Although petitioner testified credibly about the fact that he also paid his drivers in cash, he provided no basis on which the court could make an educated estimate as to how much he paid—thus the court refused to “hazard a guess as to what additional amounts might be properly deducted or excluded from his gross receipts.”

*Takeaway:* The importance of maintaining receipts cannot be emphasized enough. Accountants should be sure to remind their clients. People make fun of those old clients who would keep a shoebox of receipts to bring to their tax return preparer, but a box of receipts like that might have made a huge difference in this case.

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[Rowe v. Commissioner](#) – another substantiation failure

Petitioners have run a cruise travel business for more than twenty years. Their company receives a 3% commission on every cruise they sell. The business generally runs at a loss, as the expenses they claim each year greatly exceed their commission income. Although petitioners listed a variety of expenses on their Schedule C, the bulk of their deductions come from travel expenses and deductions for meal and entertainment expenses. The Service audited their 2017 income tax return and requested information to substantiate the claimed business expenses. Petitioners provided a seven-page expense log listing nine different events that they claim to have attended during 2017 in relation to their travel business, such as cruise seminars and conventions. Each entry had a list of expenses associated with it, such as hotel room rental, airfare, food, entertainment and open bar. No receipts were provided to support any of the listed expenses. Petitioners also submitted partial copies of their credit card statements, but the information listed there was incomplete and did not correspond to any of the entries or dates on the expense log. The auditor also required that they complete a Form 886-A, Schedule C-4-General Questionnaire, and to detail their travel expenses on Form 886-A, Schedule C-7-Travel, Meals and Entertainment Expenses. The dates they provided on the Schedule C-7 did not correspond with the dates on the expense log, and the only credit card entry that tied into the Schedule C-7 did not have a dollar amount associated with it. The Service therefore issued a notice of deficiency disallowing \$2,480 of meal and entertainment expenses and \$53,738 of travel expenses.

The court emphasized that the taxpayer bears the burden of proof to claiming any deductions. As explained above, [Code section 162](#) permits taxpayers to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Unlike in *Nurumbi*, whether the expenses themselves were in fact ordinary and necessary was the main focus in this case. Ordinary has been held to mean "normal, usual, or customary," [Deputy v. du Pont](#), while necessary means "appropriate and helpful," [Welch v. Helvering](#), and reasonable in relation to its purpose, [Boser](#).

The court held that petitioners failed this burden as they did not show that the expenses they claimed to have incurred were reasonable in relation to their purpose. The room rental, entertainment, food and open bar costs from just one of the listed trips exceeded the total annual revenue in almost every year of the travel agent business. The court held that these costs could therefore not be reasonable in relation to their purpose of generating revenue for the business.

Additionally, even if some explanation could have been provided to establish the expenses as reasonable, the deductions would still be disallowed as petitioners failed to adequately substantiate them. Similar to expenses incurred in the use of vehicles, the substantiation requirements are also heightened for expenditures such as travel, entertainment, and meal expenses [\[Code section 274\(d\)\(1\)\]](#). Like the petitioner in *Nurumbi*, petitioners here had to provide "adequate records" to determine the amount of each expense, the time and place it was incurred, the business purpose for the expense, and the business relationship of petitioners to the person receiving the benefit of the incurred expense. As petitioners' expense log was not supported by or corroborated with any documentary evidence such as receipts, paid bills or similar paperwork, or in fact any other corroborating evidence, the court ruled that it could not allow their deductions.

Note that the Service raised at trial for the first time that petitioners' travel business may really be a hobby and not a business, thus offering an alternative theory upon which the deductions could have been disallowed. [Code section 183](#). The court held that allowing the hobby issue to be raised for the first time so late in the proceedings would constitute unfair surprise for petitioners, particularly as they are pro se litigants. Interesting to consider whether the court would have reached the same conclusion if petitioners had been able to adequately substantiate their deductions.

*Takeaway:* Just another example of the importance of holding on to receipts if you intend to deduct expenses. Return preparers should emphasize this to every taxpayer, as the ramifications are severe for failure to properly substantiate the expenses claimed on a tax return.

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