

WILLIAM & TRACY E. FANNING '
18730 Canoe Brook Lane
Toney, AL 35773,

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers,

DOCKET NO. INC. 99-395

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed 1992 through 1995 income tax against William and Tracy E. Fanning (ATaxpayers@). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on November 17, 1999. Greg Cook represented the Taxpayers. Assistant Counsel David Avery represented the Department.

ISSUES

The issue in this case is whether the Department correctly computed the Taxpayers= liabilities for the years in question. That issue includes the following sub-issues:

- (1) Should the Taxpayers be allowed to file separate Alabama returns for the subject years;
(2) Did the Department properly disallow various deductions claimed by the Taxpayers in the subject years;
(3) Should the Department allow travel expenses based on a Areconstructed@ logbook submitted by the Taxpayers; and,
(4) Did the Department properly calculate the Taxpayers= gross income during the subject years using the best information available?

FACTS

William Fanning operated a construction business during the years in issue. Both Taxpayers were also involved in a criminal scheme during those years in which they cooperated with a third party to embezzle money from a corporation. The Taxpayers received an unknown amount of cash from the scheme.

The Taxpayers=scheme was uncovered, and the Revenue Department assisted in the criminal investigation of the Taxpayers. William Fanning subsequently pled guilty to criminal failure to file Alabama income tax returns and pay the tax due. Tracy Fanning pled guilty to criminal conversion of property.

The Taxpayers failed to file Alabama income tax returns for the subject years. The Department used the Taxpayers= bank deposits and other information discovered in the criminal investigation to prepare returns for the Taxpayers. The final assessments in issue are based on those estimated returns. The Taxpayers appealed.

At the November 17, 1999 hearing, the Taxpayers= representative requested an opportunity to file returns for the Taxpayers. The request was granted. The Taxpayers subsequently filed separate returns for all years. Tracy Fanning claimed the standard deduction on her 1994 and 1995 returns. William Fanning itemized deductions in those years.

The Department reviewed the returns, and made the following findings:

(1) The Department allowed the Taxpayers to file separate returns for the subject years. However, Tracy Fanning was not allowed to claim the standard deduction in 1994 and 1995 because her spouse had itemized deductions in those years. See, Dept. Reg.

810-3-15-.19(4). Nonetheless, Tracy Fanning owes no tax for 1994 and 1995.

(2) The Taxpayers submitted canceled checks from their personal account and a reconstructed logbook to verify their business and travel-related expenses for the subject years. The Department disallowed the canceled checks because the Taxpayers failed to provide invoices, receipts, or other evidence establishing that the checks were for valid business expenses. The Taxpayers claim that their business records were destroyed in Hurricane Opal in 1995. The reconstructed logbook was also rejected based on 26 U.S.C. ' 274(d), as amended in 1984. The Department argues that ' 274(d) requires that travel expenses must be verified by contemporaneously maintained records. The Taxpayers provided no such records. The Department also disallowed an unverified federal tax-paid deduction claimed by the Taxpayers, but allowed verified home mortgage interest.

(3) The Department treated the Taxpayers as part-year Alabama residents in 1995 based on their claim that they moved to Florida in that year. The Department accordingly removed Florida income reported on their 1995 returns from income subject to Alabama tax.

ANALYSIS

The Taxpayers were required to keep adequate records from which their correct tax liability could be computed by the Department. Code of Ala. 1975, ' 40-2A-7(a)(1). The burden was also on the Taxpayers to provide records verifying all claimed deductions. Without such records, all deductions must be disallowed. *McDonald v. C.I.R.*, 114 F.3d 1194 (1997); *Jones v. C.I.R.*, 903 F.2d 1301 (1990); *Doyal v. C.I.R.*, 616 F.2d 1191 (1980).

All taxpayers are required to keep records to enable the Commissioner to determine their correct tax liability. Sec. 6001; *Meneguzzo v. Commissioner*, 43 T.C. 824, 831-832, 1965 WL 1240 (1965). Deductions are a matter of legislative grace, and the taxpayer bears the burden of proof to establish entitlement to any claimed deduction. Rule 142(a); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440, 54 S.Ct. 788, 78 L.Ed. 1348 (1934). This includes substantiation of the deductions claimed. *Hradesky v. Commissioner*, 65 T.C. 87, 90, 1975 WL 3047 (1975), affd. per curiam 540 F.2d 821 (5th Cir. 1976).

Hentges v. C.I.R., T.C. Memo. 1998-244 (U.S. Tax Ct., 1998).

The Taxpayers failed to provide records to verify most of the deductions claimed on their returns. The Taxpayers claim their records were destroyed by Hurricane Opal in 1995. In such cases where records are destroyed though no fault of a taxpayer, the taxpayer may reasonably reconstruct such records. *Hentges v. C.I.R.*, supra; ' 1.274-5T(c)(5), Temporary Income Tax Regs., 50 Fed.Reg. 46006, 46021-46022 (Nov. 6, 1985).

In this case, however, the Taxpayers presented only personal checks, without tangible evidence that the checks were for valid business expenses. The Department is not required to rely on the Taxpayers' verbal assertions. *State v. Ludlum*, 384 So.2d 1089 (Ala.Civ.App.), cert. denied 384 So.2d 1094 (Ala. 1980). Without some evidence that the checks were for business-related expenses, the deductions must be denied.

Concerning the travel expenses, 26 U.S.C. ' 274(d), as amended in 1984, overruled the Cohan rule, and now requires that a taxpayer must maintain contemporaneous records of such expenses. A reconstructed estimate of expenses is not sufficient.

The substantiation requirements of section 274(d) with respect to expenses for travel away from home, meals, entertainment, and expenses relating to the use of listed property effectively preclude this Court from the use of application of the Cohan rule, *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), in allowing deductions for expenses where the Court is satisfied from the record that expenses have been incurred but the taxpayer

has not adequately substantiated the amount of such expense. Unless the stringent substantiation requirements are met for those categories of expenses covered by section 274(d), this Court has no choice but to disallow such expenses.

Hentges v. C.I.R., supra.

Because the Taxpayers failed to maintain a contemporaneous record of travel expenses, the claimed expenses must be disallowed.

In the absence of adequate records, the Department is authorized to use the best available information to compute a taxpayer's liability. Code of Ala. 1975, '40-2A-7(b)(1)a. The Department thus properly used the Taxpayers' deposit records to compute their gross income in the subject years. In doing so, the Department properly removed all nontaxable deposits from income.

Although the above result may seem harsh, it must be remembered that the Taxpayers initially failed to file Alabama returns for the years in question. Even if it is accepted that their records were destroyed in 1995, they failed to provide third-party vendor or other information from which allowable deductions could be reasonably estimated. The Department cannot be required to accept the Taxpayers' claims without some tangible proof. It is also possible that some of the cash they received from their criminal activity was never deposited into their account, and thus never taxed by the Department.

The final assessments, as adjusted, are affirmed. Judgment is entered against the Taxpayers, jointly, for 1992 tax, penalty, and interest of \$11,636, and 1993 tax, penalty, and interest of \$7,788.61. Judgment is entered against William Fanning, individually, for 1994 tax, penalty, and interest of \$16,224.78, and 1995 tax, penalty, and interest of

\$8,417.74.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, ' 40-2A-9(g).

Entered December 7, 2000.