

MATTHEW W. & CINDY C. LOWERY §
10 Jill Lane
Anniston, AL 36201, §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 03-393

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Matthew W. and Cindy C. Lowery (“Taxpayers”) for 2000 and 2001 income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. Hearings were conducted on August 18, 2003 and April 15, 2004. Jess Buckner represented the Taxpayers at both hearings. The Department was represented by Assistant Counsel Keith Maddox at the August 18 hearing, and Assistant Counsel Mark Griffin at the April 15 hearing.

The Taxpayers live in Anniston, Alabama. Mr. Lowery is employed with the Anniston Fire Department. Mrs. Lowery started a photography business in late 2000. The Taxpayers maintained two bank accounts during the subject years – a joint personal account and a photography business account in the name of Cindy Lowery Photography.

The Department audited the Taxpayers’ income tax returns for 2000 and 2001. The Taxpayers had erroneously claimed Mrs. Lowery’s photography-related expenses on a Schedule A in 2001 instead of a Schedule C. At some point in the audit process, the Taxpayers’ current representative was instructed to prepare a 2001 Schedule C. The representative prepared a Schedule C and, as instructed, submitted it to the Department in Montgomery. The Department rejected the Schedule C, presumably because it was not accompanied by a return. The Department subsequently entered the final assessments in

issue.

At the August 18, 2003 hearing, the Taxpayers presented records in support of the deductions claimed on their 2001 return. The Department examiner allowed some of the claimed deductions. She disallowed others because either she deemed that they were not sufficiently substantiated, or she could not determine that the documented expense was for a business purpose. The examiner also increased the Taxpayers' 2001 income because total deposits into the business checking account exceeded the income reported for the business in that year. As a result of the disallowed deductions and the additional income, the examiner increased the Taxpayers' 2001 liability from \$614.52 to \$859.88. She did not adjust the Taxpayers' 2000 liability, as assessed, because no records were provided for that year.

The burden is generally on a taxpayer to substantiate all claimed deductions. *Norgaard v. C.I.R.*, 939 F.2d 874 (1991). Certain business-related expenses such as travel, entertainment expenses, and business gifts are particularly susceptible to abuse. Consequently, those expenses must be substantiated as to amount, time and place, and business purpose for the expense. See generally, 26 U.S.C. §274.¹ For entertainment and gifts, the business relationship between the taxpayer and the person being entertained or receiving the gift must also be substantiated. And while some deductions may be reasonably estimated in the absence of adequate records pursuant to *Cohan v. Commissioner*, 39 F.2d 540 (1930), the *Cohan* rule does not apply to business-related

¹ Alabama law provides for the same business-related deductions as does federal law at 26 U.S.C. §162, see Code of Ala. 1975, §40-18-15(a)(1). Consequently, the federal recordkeeping requirements at §274 also apply.

travel, entertainment, and business gifts. The requirements for substantiating such expenses are explained in the CCH U.S. Master Tax Guide, at ¶953, as follows:

In order to claim any deduction, a taxpayer must be able to prove that the expenses were in fact paid or incurred. The following expenses, which are deemed particularly susceptible to abuse, must generally be substantiated by adequate records or sufficient evidence corroborating the taxpayer's own statement: expenses with respect to travel away from home (including meals and lodging), entertainment expenses, business gifts, and expenses in connection with the use of "listed property" (such as cars and computers – see ¶1211). The expenses must be substantiated as to (1) amount, (2) time and place, and (3) business purpose. For entertainment and gift expenses, the business relationship of the person being entertained or receiving the gift must also be substantiated. (Temporary Reg. §1.274-5T(a)-(c).

A contemporaneous log is not required, but a record of the elements of the expense or use of the listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility. Adequate accounting generally requires the submission of an account book, expense diary or log, or similar record maintained by the employee and recorded at or near the time of incurrence of the expense. Documentary evidence, such as receipts or paid bills, is not generally required for expenses that are less than \$75. Documentary evidence for lodging expenses is required (Temporary Reg. §1.274-5T(c)(2)iii)). The employee should also maintain a record of any amounts charged to the employer.

The *Cohan* rule, which may be used by the courts to estimate the amount of a taxpayer's expenses when adequate records do not exist, may not be used to estimate the expenses covered by Code Sec. 274 (Temporary Reg. §1.274-5T(a)(1)). However, if a taxpayer has established that the records have been lost due to circumstances beyond the taxpayer's control, such as destruction by fire or flood, then the taxpayer has a right to substantiate claimed deductions by a reasonable construction of the expenditures or use (Temporary Reg. §1-274-5T(c)(5)).

As indicated, the Taxpayers' representative provided the Department examiner with cash register tapes, invoices, and various other records to substantiate the deductions claimed on the Taxpayers' 2001 Schedule C. The Department examiner scheduled the records in her audit report as to date, document type, payee, amount allowed,

unsubstantiated amount (amount disallowed), and category. She also added a comment explaining why each disallowed item was disallowed.

The first category listed by the examiner is “advertising.” She disallowed three items totaling \$237.98 because either there was no proof of payment or no description of what the receipt was for. The Taxpayers explained at the April 15 hearing that the expenses were for advertising in the Yellow Pages and for advertising at a mall in Anniston. Those expenses should be allowed.

The next category is “auto expenses.” The examiner allowed all claimed auto expenses except a \$21.85 invoice from Wallpaper For Less because she could not determine a business purpose for that expense. The Taxpayers did not explain the expense at the hearing. That expense was thus properly disallowed.

The next category is “depreciation.” The examiner disallowed depreciation on three items. The Taxpayers explained that a \$2,820 cashiers check to Photo King was for a camera for Mrs. Lowery’s business. That should be allowed. The other two items, one of which may have been redundant, were properly disallowed.

The next category is “gifts,” which, as discussed above, must be clearly documented as to business purpose, etc. The Taxpayers explained what the gifts were for at the April 15 hearing. They admittedly failed, however, to keep adequate contemporaneous records as required by law. The gifts were correctly disallowed.

The Taxpayers also claimed insurance on their home. They explained that Mrs. Lowery’s cameras are kept at the house. While the Taxpayers may be entitled to a home office deduction, they cannot deduct the hazard insurance on their personal residence.

The examiner disallowed all of the meals and entertainment expenses claimed by the Taxpayers because they were not substantiated and there was no proof of a business purpose. Like the gifts discussed above, those expenses were correctly disallowed.

Two of the twenty five deductions for office supplies claimed by the Taxpayers were properly disallowed because there was no proof of payment.

The examiner next disallowed various items as personal in nature. Mr. Lowery testified that he purchased one of the items, a pistol for \$675, relating to his duties with the Anniston Fire Department. The Department examiner explained that she disallowed the expense on the Schedule C because it did not relate to Mrs. Lowery's photography business. She conceded, however, that it should be allowed on Schedule A. Consequently, if that item was not already deducted by the Taxpayers on their Schedule A, it should now be allowed. The same applies to \$276 worth of items relating to the events of September 11, 2001 that Mr. Lowery bought in New York and donated to the Anniston Fire Department. The other items were properly disallowed because the Taxpayers failed to establish a clear business purpose for the items.

The examiner allowed most of the supplies claimed by the Taxpayers, but disallowed some because either a business purpose was not documented or there was no proof of payment. The Taxpayers speculated that some of the disallowed items were business-related. However, most of the items could also have been for personal use. The examiner's findings concerning the supplies are affirmed.

Concerning the additional income added by the examiner, the Taxpayers explained that when they were starting Mrs. Lowery's photography business, they transferred money from their personal account to the business account. If that is the case, those deposits

would be non-taxable. However, the Taxpayers have presented no evidence proving or verifying that they deposited or transferred money from their personal account to their business account. Consequently, the examiner correctly included the unexplained deposits as taxable income.

The Department examiner performed an excellent audit and was a good witness at the hearings in the case. The fact that some deductions she disallowed are being allowed is not a criticism of her work. Rather, the expenses are allowed based on the records submitted by the Taxpayers and their credible testimony at the April 15, 2004 hearing.

The Department is directed to recompute the Taxpayers' 2001 liability as indicated above. A Final Order will then be entered.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered July 6, 2004.

BILL THOMPSON
Chief Administrative Law Judge