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Reconstructing Income and Expenses:  
Representing the Taxpayer Without  
Adequate Books and Records



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# Overview



# The cost of the tax gap

Approximately one-third of the annual tax gap is a result of under-reported income or overstated deductions on a Schedule C business.

- <https://www.eitc.irs.gov/tax-preparer-toolkit/schedule-c-and-record-reconstruction-training/eitc-due-diligence-and-self>



# Income Reconstruction

- **Preparer Question:** I have a client who is self-employed but has no receipts for income or expenses. Should I refuse to prepare the return?

<https://www.eitc.irs.gov/tax-preparer-toolkit/frequently-asked-questions/earned-income-self-employment-income-and-business>



# Income Reconstruction

- **IRS Answer:** Not necessarily. You can take the opportunity to teach your clients about record-keeping requirements. If your client has any records and data on the amount earned and any expenses, you can explain how to reconstruct and/or help make a reasonable estimate of the income earned and expenses. If you choose to help your client reconstruct the records, be sure to document how you computed the income and expenses. Refusing to prepare the return is a decision only you can make.



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# Due Diligence



# Preparer due diligence – interview your client

- Client interview and targeted questions meant to assess how income can be recreated.
- Estimate time it will take and who will complete each action step.
- Determine commitment of client to cooperate in the time it will take to reconstruct.



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# Preparer due diligence

- Be mindful of :
  - Businesses with overstated expenses
  - Business with round numbers for income and expenses
  - Taxpayer receives a 1099 MISC when they should have received a W-2





## Does it make sense?

- Being diligent in evaluating taxpayer's personal assets and expenses to assess whether lifestyle is consistent with income reconstruction
- See IRS form 4822 :  
<http://www.zillionforms.com/2005/F482.PDF>



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# Income Reconstruction



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# Goal of Record Reconstruction

- Use available documentation to develop a **sound and reasonable estimate** of the taxpayer's business income and expenses to support the [tax return] prepared.
- Return preparers will not be penalized for using their professional judgment in deciding whether to use estimates.



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# Record Reconstruction

- Determine exactly what records have been lost
- Prioritize importance of lost items
- Consider the time and expense locating lost items
- Determine sources to obtain lost items  
(transcripts, FOIA, state and local agencies,  
financial institutions)

# IRS Reconstruction Methods

- Bank Deposits and Cash Expenditures Method
  - compares the total deposits plus cash expenses minus nontaxable sources of income to the total receipts shown on the return.
- Markup Method
  - uses a common denominator within the business records to identify unreported income.
- Net Worth Method
  - $\text{Assets, less Liabilities} = \text{Net Worth}$



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# IRS Reconstruction Methods

- Source and Application of Funds
  - uses changes in assets and liabilities, along with expenditures for nontaxable income and nondeductible receipts.
- Unit and Volume Method
  - gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer .



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# Foundation for Record Reconstruction



TABLE 1

| Example source <sup>1</sup>  | How to use to reconstruct records  |
|--|--|
| Appointment books or calendars   | <p>An appointment book could be used to develop:</p> <ul style="list-style-type: none"><li>• Where a taxpayer traveled to provide services, and how many trips</li><li>• A count of how many people were provided services</li><li>• A count of how many of each type of service was rendered; for example, how many hair cut appointments, how many manicure appointments</li></ul> <p>Using summary counts of the number of each kind of service rendered, the taxpayer could apply an average or standard cost to come up with an estimate of total receipts. The number of trips made and the locations traveled to could be combined with online map tools data to support total business miles driven.</p> |
| Online map tools   | Online map tools can be used to reconstruct mileage calculations.  |
| IRS standard allowances  | The IRS provides standard expense allowances including per diem expenses for truck drivers and standard mileage rates.   |
| Checkbook, cancelled checks, bank statements or credit card statements | These documents can be used to gain information about expenses incurred and what types of services were performed for clients. Using summary counts of the number of each kind of service rendered, the taxpayer could apply an average or standard cost to come up with an estimate of total costs and receipts.  |
| List of regular clients  | Using a list of regular clients, a taxpayer could reconstruct a reasonable calendar of services. Regular expenses could be extrapolated from that information. The taxpayer could apply an average or standard cost to come up with an estimate of total receipts.   |
| Partial receipts or sales tax records                                  | Partial receipts can lend information regarding what expenses were incurred for services. The taxpayer could apply an average or standard cost to come up with an estimate of total receipts.  |
| Cell phone records and call history or computer logs                   | Cell phone records and call history can be used to develop a list of clients served during specific timeframes.  |
| Prior year returns   | Prior year returns can provide the basis for records if activities are similar from year to year.  |





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# Foundation for Record Reconstruction – Documents

- Bank Statements
- IRS Form 4822 “Statement of Annual Estimated Personal and Family Expenses”
- IRS National Standards
- IRS Wage & Income Transcripts
- Credit Report

# Foundation for Record Reconstruction – Documents

- Internet Asset and Judgment Searches
- Invoices and receipts
- Cancelled checks
- Credit cards slips
- Real-estate closing statements
- Online Maps tools



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# Foundation for Record Reconstruction – Industry Standards



**sageworks**





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# COHAN RULE



# Deductions in General

“Deductions are a matter of legislative grace; taxpayers bear the burden of substantiating their claimed deductions by keeping and producing records sufficient to enable the Commissioner to determine the correct tax liability.” INDOPCO, Inc. v. Comm’r, 503 U.S. 79, 84 (1992)



# Issues Raised in Litigated Cases

| Issue   | Type of Taxpayer |          |
|---|------------------|----------|
|   | Individual       | Business |
| Substantiation of Expenses Under IRC § 162, Including Application of the <i>Cohan</i> Rule                    | 3                | 44       |
| Substantiation of Expenses Under IRC § 274(d)   | 9                | 23       |
| Schedule A Unreimbursed Employee Expenses Requiring Proof Employer Did Not Reimburse Taxpayer Under IRC § 162 | 14               | 5        |
| Hobby Losses, Nondeductible Under Either IRC §§ 183 or 162  | 1                | 12       |
| Home Office Under IRC § 280A  | 0                | 3        |
| Net Operating Losses Under IRC § 172  | 0                | 7        |
| Personal Expenditures Disallowed Under IRC § 262  | 2                | 1        |
| Capitalization and Cost Recovery Under IRC §§ 263, 263A, 195, 179, and 167                                    | 3                | 9        |
| Illegal Activities Under IRC §§ 280E, 162(c), 162(f), and 162(g)  | 0                | 1        |
| Economic Substance Doctrine   | 1                | 3        |
| Business Bad Debt Deduction Under IRC § 166   | 0                | 10       |
| Not Engaged In a Trade or Business Under IRC § 162  | 2                | 10       |
| Interest Deduction Under IRC § 163  | 0                | 2        |



# Authority for Estimates - Cohan Rule

- When the TP establishes that the TP paid or incurred deductible expenses but does not establish the amount of the deduction to which TP is entitled, TP may be entitled to estimate the amount allowable. Cohan v. Comm'r, 39 F.2d 540 (2d. Cir. 1930)



# Application of Cohan Rule

- “[T]o qualify for the estimation treatment under Cohan, the taxpayer must establish that he is entitled to some deduction.”
- “[A] court should allow the taxpayer some deductions if the taxpayer proves he is entitled to the deduction but cannot establish the full amount claimed”
- “bearing heavily ... upon the taxpayer whose inexactitude is of his own making”





# Application of Cohan Rule

- Burden of Proof:
  - Generally the taxpayer has the burden of proof
  - §IRC 7491(a) shifts burden of proof to IRS when the taxpayer:
    - Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability;
    - Complies with the requirements to substantiate deductions;
    - Maintains all records required under the Code; and
    - Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

# Limits on Record Reconstruction – Section 274

- Section 274 prohibits claiming the following deductions unless substantiation requirements are maintained:
  - Meals and entertainment
  - Travel
  - Gift Expenses
  - Listed Property Expenses
- TCJA eliminates the above deductions for employees.
- Estimates for these expenses are allowed only if the taxpayer lost records due to fire, flood or other catastrophe.



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# *Bauer v. CIR, T.C.Memo. 2012-156*

- TP operated furniture moving business and employed short-term labor paid in cash
  - IRS estimated contract labor as % of receipts, based on BizStats “freight trucking” category
  - Tax Court held for TP that BizMiner “household goods transport” category was more representative: allowed deduction for higher % of receipts



# Expert Testimony

## Expert

An expert is someone with some experience through extensive knowledge called in for advice.

# Foundation for Record Reconstruction- Testimony

- Oral Testimony
  - I.R.M. 4.10.7.3.2(01-01-2006)
- First Hand Knowledge
  - I.R.M. 4.10.7.3.3 (01-01-2006)
- Expert Testimony
  - I.R.M. 4.10.7.3.4 (01-01-2006)



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Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent

Docket No.

## PETITIONER'S EXPERT REPORT

### Identifying Information

This report is submitted on behalf of Petitioner(s). For the reasons set forth above, I opine as follows:

### Qualifications of the Expert

Tax Court Rule 143(g) requires that the Report include the witness's qualifications, including a list of all publications authored in the previous 10 years, and a list of all other cases in which, during the previous 4 years, the witness testified as an expert at trial or by deposition. My qualifications include:

Education

Training

Work Experience, including cases in which the witness testified as an expert witness



# F.R.E. Rule 702

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

- (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
- (b) the testimony is based on sufficient facts or data;
- (c) the testimony is the product of reliable principles and methods; and
- (d) the expert has reliably applied the principles and methods to the facts of the case.

# *Feinberg v. CIR* T.C. Memo 211 (T.C. 2017)

- At trial, the taxpayer did not submit documentation to substantiate the cost of goods sold allowance or the ordinary and necessary business expenses. Instead, an expert report was submitted to substantiate a cost of goods sold allowance in excess of what the IRS allowed during the examination.
- The Tax Court ruled that the expert report was unreliable because it contained statements which failed to refer to underlying source information, failed to include underlying source information which the expert relied upon, and failed to include sufficient information and data to support the report's conclusions. As a result, the expert report was inadmissible



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Questions?