Beacon
SMALL BUSINESS SOLUTIONS

Lessons from the Tax Court

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In my years as a Hospital Administrator, I liked to read court summaries of medical malpractice actions to better understand how bad acts are treated in the legal system. Understanding what not to do is often a good guide to better learn what we should be doing.

So it is with summaries of Tax Court cases. Here are some excerpts from TaxPro, a publication of the National Association of Tax Professionals. I hope that understanding the Court's thinking will give you insights into how things we have wondered about are viewed.

"Just Because I Say So" Isn't Enough

In one 2007 case, a taxpayer tried to claim dependency exemptions for two of his children who were both over 19 years old and not full-time students.

Moreover, both had jobs that generated sufficient income and were required to file their own tax returns.

Moreover, this same taxpayer claimed a dependency exemption for a third person who was not his child, but could not provide any documentation other than his own testimony that he provided room, board, and other support.

But this story goes on. The taxpayer reported five different businesses on his tax return, but was unable to prove that there was a profit motive for any of the businesses, or that the businesses were operated with any "continuity and regularity".

The taxpayer was unable to provide any documentation for any of the businesses, all of which lost money. The only evidence he presented to the Court was his own testimony, which by this time the Court was not inclined to believe….

There is still more to this story. This taxpayer had not filed any tax returns for several years. When asked why, he cited 29 health reasons that prevented him from doing so. So the Court asked him why he didn't pay someone to prepare his returns, he responded that he didn't like to commit things he cannot pay for.

Inevitably, the Court ruled against him on all three counts: the 3 dependents, the 5 failed businesses, and of course the failure to file multiple returns.

The lesson is simple: If you want IRS to work with you, file your returns on time. Provide credible documentation to back up your expense claims. And operate your business with continuity and regularity consistent with a profit motive.

Professional Gambling As A Business

Another 2007 Tax Court decision involved a self-employed individual who maintained a successful, legitimate business thatreported $21,000 in earnings on his Schedule C (the IRS profit and loss form for an unincorporated business).

So far, so good. But he reported another Schedule C reporting some $83,000 of gambling winnings. This income was offset by a Schedule A deduction for the same amount,

Still OK. The Tax Code permits us to deduct gambling losses to the extent of gambling winnings. Thus, we neither gain nor lose when we gamble, provided we keep accurate records.

This case turned on whether the gambling was truly a business operated with a profit motive, and was operated with consistency and regularity. (There are those terms again.)

A case like this depends on a review of the individual facts and circumstances. In this case, the taxpayer gambled 900 hours over a 136-day period, approximately 17 hours/week.

It was clear from the tax return that the taxpayer relied on more than his gambling activity to support himself.

And finally, the taxpayer failed to keep reliable records of his gambling activity, which supported the conclusion that he did not gamble with the intention of making a profit.

The Tax Court concluded that the gambling activity was "consistent with gambling purely for its entertainment or recreational aspect."

The Schedule C part of the return was disallowed, and the $83,000 of winnings was reported on the first page of the tax return as gambling winnings.

The gambling losses were still allowed as a Schedule A deduction, so the two $83,000 figures cancelled each other.

Because the losses cancelled the winnings, you'd think the taxpayer would still not have a problem, but he did.

Because the winnings are on the first page of the tax return, they are included in Adjusted Gross Income. The gambling winnings, when combined with other income sources, caused a huge jump in income.

And that jump ultimately was so great that the itemized deductions were limited, and the Child Tax Credit was eliminated.

Result? More taxes. They got him. He had tricked the tax return to reduce his legitimate share of taxes.

Guess what the other business was. Tax and accounting practice.

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