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Golly Gee—the U.S. Tax Court Ruled That the Cost of a Taxpayer's Microsoft Xbox 360 and a Nintendo Wii Used by His Children Did Not Constitute Ordinary and Necessary Business Expenses Deductible Under IRC § 162 or Amortizable Under IRC § 167&m

By Larry Brant on 7.25.17 | Posted in Business Taxes, Corporate Tax, Tax Laws

In 2015, the U.S. Tax Court issued its ruling in the case of *David W. Laudon v. Commissioner,* TC Summary Option 2015-54 (2015).[1] The case may not raise or even resolve any novel tax issues, but it reminds us of what is hopefully the obvious relative to the deductibility of business expenses. The Court's opinion and its recitation of the underlying facts, however, make for an extremely interesting and entertaining read.

BACKGROUND

The taxpayer, David W. Laudon, was a chiropractor licensed to practice chiropractic medicine in the State of Minnesota.[2] His dispute with the Internal Revenue Service ("IRS" or "Service") involved at least three items relating to Schedule C of IRS Form 1040 for Tax Years 2007-2009:

1. Business receipts of approximately $290,000 were deposited into the taxpayer's business bank accounts, but only about $210,000 made their way onto his income tax returns.
2. Business expenses for operating the taxpayer's home office included the cost of several items not customarily found in a chiropractic physician's office, including a Microsoft Xbox 360, a Nintendo Wii, several big screen televisions, and hair salon equipment.
3. A substantial deduction for mileage equating to tens of thousands of miles each year were allegedly driven by the taxpayer in the ordinary course of treating patients.

Upon audit, the IRS agent likely focused attention on the taxpayer's Schedule C, when it became evident that the taxpayer did not maintain records of his income and expenses in "any decipherable form." Adding fuel to the fire, Dr. Laudon, who represented himself in the matter, responded with incredible explanations to many of the auditor's inquiries about his financial

recordkeeping and the support for his business expenses. With the government finding that many of Dr. Laudon's explanations strained credibility, the scene was set for an all-out battle. Yes, that battle ensued.

UNDERREPORTED INCOME

Dr. Laudon failed to keep books and records supporting his business income. Consequently, the Service reconstructed the taxpayer's business income by analyzing his bank accounts. The Court ruled that, provided the Service shows that the taxpayer operated an income-producing business during the tax years at issue, and that he made regular deposits into the bank accounts, this long-honored method of reconstructing income is acceptable. The Service must, of course, give the taxpayer the opportunity to distinguish taxable deposits from nontaxable deposits made during the tax years at issue.

Using this accepted method of reconstructing income, the Service determined that Dr. Laudon underreported his business income by approximately $80,000 in the aggregate for the tax years at issue. Once this determination was made, the taxpayer was given the opportunity to show that the government's determination was erroneous. Unfortunately, Dr. Laudon failed to meet that burden. In fact, according to the Court's written opinion, he did not produce *any* credible evidence to rebut the government's position. Rather, he threw out several far-fetched, unsupported allegations, to hopefully reduce the claim that he underreported income, including:

1. That some of the deposits were nontaxable reimbursement payments from his automobile insurer to pay for repairs to several of his vehicles, one of which he claimed was involved in a "high speed police chase" with a man "high on meth and cocaine."
2. That some of the deposits were from the sale of personal use property at no gain.
3. That some of the cash deposits ($6,000 or maybe $7,850) were lost by Wells Fargo and otherwise unavailable to him.

As already stated, Dr. Laudon could not produce any evidence to support these allegations. Consequently, the Court accepted the IRS's determination of income.

EXPENSES

The IRS denied approximately $175,000 in the aggregate of Dr. Laudon's business deductions for the tax years at issue. As we know, a taxpayer may claim a deduction for his or her ordinary and necessary expenses paid or incurred in carrying on a trade or business. The taxpayer bears the burden to meet this standard. Most taxpayers meet the burden with the production

of supporting business records, including receipts.

Dr. Laudon's business expenses at issue are best broken down into five categories, namely:

1. Automobile;
2. Home office;
3. Insurance, repairs, utilities, office and wages;
4. Other expenses; and
5. Depreciation.

Automobile. Dr. Laudon took aggregate mileage deductions for travel through the Dakotas and Minnesota of about $80,000 for the tax years at issue. In fact, he claimed that he racked up between 40,000 and 60,000 miles each year, traveling in vehicles for business purposes. In trying to support this extraordinary amount of business travel, he testified that his patients called upon him night and day, and that he often traveled to see these patients who were in need of medical assistance. In fact, he claimed that his patients often called him a "psychiatrist," a "chauffeur," a "physician," a "peace officer," and even a "pheasant hunter."

The government's response to Dr. Laudon's somewhat comical statements was that the mileage and the rationale for the alleged business trips would have made much more sense if the taxpayer had claimed to be a "ghostbuster" rather than "psychiatrist," "chauffeur," "physician," "peace officer," or "pheasant hunter." As the lyrics to the theme of the movie *Ghostbusters* provide in part:

"If there is somethin' strange in you neighborhood, who ya gonna call? Ghostbusters! If it's somethin' weird, an' it don't look good, who ya gonna call? Ghostbusters!"

Not to give the government the last comical word, Dr. Laudon then claimed his business mileage was supportable for many reasons, including his need on several occasions to travel down the Minnesota highway to reach a patient that was "running scared of demons," or to perform medical procedures (which unfortunately testimony showed he was unlicensed to perform).

The Court ultimately concluded no evidence was produced to support any of the business mileage. While Dr. Laudon had a mileage log of sorts, it was "incomplete" and "incomprehensible."

In order to support travel expenses, Code Section 274(d) requires that taxpayers keep an adequate written record which shows:

1. The amount of each expense;
2. The date and place of vehicle travel; and
3. The business purpose of the travel.

Home Office Expenses. Dr. Laudon deducted approximately $8,000 in the aggregate for home office expenses during the tax years at issue. The IRS denied all of these expenses.

Code Section 280A requires a taxpayer to show that he/she used a portion of his/her home exclusively for business purposes on a regular basis. In the instant case, Dr. Laudon claimed his entire basement and garage were used exclusively for business purposes. Unfortunately, his own testimony planted a torpedo directly into the middle of his position.

The Court expressly stated disbelief that a basement filled with an Xbox, Wii, big screen televisions, other entertainment devices, and hair salon equipment was exclusively used by the taxpayer for his chiropractic business. In fact, during audit, Dr. Laudon admitted that his daughter and his girlfriend's son often used the Xbox, Wii and televisions to play video games in the basement. Also, Dr. Laudon himself testified at trial that he routinely stored his personal use vehicles in the garage. Consequently, the clearly-required, "regular" and "exclusive" use standard was not attained. The taxpayer lost this battle!

Insurance, Repairs, Utilities, Office and Wages. Several business expenses, including the costs of insurance, repairs, utilities, office supplies and wages were claimed by Dr. Laudon as business expenses for the tax years at issue. Unfortunately for the taxpayer, the Court upheld the government's denial of these expenses. Why? The answer is simple—the taxpayer "produced no substantiation whatsoever."

The taxpayer has the burden to show business expenses were actually incurred, and were ordinary and necessary. Here, the taxpayer produced no support for his deductions. Consequently, he lost this battle!

Other Expenses. Dr. Laudon deducted an aggregate of approximately $40,000 during the tax years at issue as "other" business expenses. Unfortunately, the taxpayer had no credible support for any of these deductions. In fact, many of the expenses related to the taxpayer's renovation of a home that he neither lived in or worked in, or even owned. The Court denied the deductibility of these expenses without further explanation. The taxpayer lost this battle!

Depreciation. The taxpayer claimed depreciation deductions for the tax years at issue. The government's assessment made downward adjustments to these depreciation deductions in amounts greater than the actual depreciation deductions claimed by the taxpayer. Obviously, this was due to clerical error, for which the government unfortunately failed to ask the Court to correct. Dr. Laudon, in turn, failed to present any evidence to support the amount of the depreciation deductions taken on his tax returns. Ultimately, the Court disallowed the amounts that the taxpayer claimed, rather than the greater amounts denied in the government's assessment. I guess this could be construed to be a small victory for the taxpayer, in that the Court's decision resulted in less of a tax liability than the government sought in its assessment on this issue.

PENALTY

Of course, given the facts presented, the IRS imposed a Code Section 6662 accuracy-related penalty. The taxpayer, as you would suspect, asserted the defense that he relied upon the advice of a tax professional.

As I have discussed in my previous blog post , this defense requires the existence of at least three facts:

1. The professional advisor is a competent professional with sufficient expertise to justify reliance;
2. The taxpayer provided the professional advisor with the necessary and accurate information to provide guidance; and
3. The taxpayer actually relied in good faith upon the professional advice.

Unfortunately for Dr. Laudon, the Court did not bother to examine requirements No. 1 and No. 3 above because evidence clearly showed that he failed to provide his advisor with accurate information. Rather, Dr. Laudon provided the same flawed and/or nonexistent information he presented to the Court. The penalty assessment, like the tax assessment, was upheld.

MORALS TO THE STORY

Here are at least four morals to this story:

1. As President Abraham Lincoln said, he who represents himself in a legal proceeding has a fool for a client.
2. Business expenses are generally deductible provided they are incurred in the conduct of a trade or business, and are ordinary and necessary.

3. Taxpayers must maintain credible and accurate business records.
4. Making outlandish and unsupported claims will get you in trouble, especially in proceedings with the IRS before the U.S. Tax Court.
5. If your imagination runs short of coming up with a credible defense to a tax assessment, consider the applicability of the "ghostbuster" defense. At least in *Laudon*, the IRS said, albeit tongue in cheek, that it was willing to entertain the defense.

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[1] In accordance with Code Section 7463(b), a Summary Opinion cannot be relied upon or cited by taxpayers as precedent.

[2] The Minnesota Board of Chiropractic Examiners lists the taxpayer's license status as "suspended" as of the time this blog article was posted.

Tags: Abraham Lincoln, Business Expenses, Ghostbusters, Microsoft Xbox 360, Nintendo Wii, Tax Penalties, Tax Procedure, taxes