A Reprint from *Tierra Grande*

A Notation a day Keeps the Auditor at Bay

by Jerrold J. Stern

Taxpayers are typically advised to keep tax-related receipts and maintain detailed records to document information reported on tax returns. A 2003 U.S. Tax Court case (*Walter L. Medlin v. Commissioner*, TC Memo 2003-224) underscores the importance of good record keeping and illustrates the significant negative consequences of poor record keeping.

Deductions Lost

Medlin, the taxpayer in the case, was engaged in buying and selling real estate, as well as real estate development. He claimed various tax deductions for his real estate businesses based on spreadsheets he prepared for deposits and disbursements from his personal bank accounts.

The spreadsheets classified disbursements as expenditures for automobiles, dues and subscriptions, office, telephone, utilities, interest, maintenance, repair, travel and entertainment, licenses and taxes, commissions paid, insurance and miscellaneous. However, Medlin had no documentation supporting these as business expenses. Consequently, the IRS "reconstructed" the spreadsheet expenses and disallowed many of the deductions.

Proper documentation would have consisted of a logbook describing the relationship between each expense and its corresponding business activity. For example, for travel and entertainment, logbook entries would have indicated the names of clients, dates of travel and detailed descriptions explaining the business purpose of the trips.

Loss of Capital Gains Status

Medlin purchased 1,600 acres of pasture that was zoned agricultural. He contended that he acquired the parcels with the intention of holding them as long-term investments. He did not develop the parcels, advertise them for sale, attempt to change the zoning of the property or initiate discussions regarding sale of the parcels.

Unfortunately, Medlin also did not document how this particular real estate investment differed from his other real estate sales. Previously, he had sold properties after developing them to varying degrees. But Medlin also had several real estate investments that he did not develop prior to sale and did not sell immediately after purchase.

He treated all of the properties as having been sold as part of his real estate business, resulting in ordinary income rather than capital gains. Thus, the tax court concluded that the purchase and sale of the 1,600 acres were part of Medlin's ordinary course of business.

Larger Taxable Gain

Medlin purchased three parcels of land for a total of $48,000. He failed to document the cost of each parcel, which he could have done by identifying the relative fair market values of each of the parcels at the time of purchase. Three years later he sold one of the parcels. At that time, he could have attempted to objectively determine its fair market value, but he did not. He nevertheless contended that the parcel had a tax basis of $24,000 (one-half of the total cost of the three parcels).

The tax court rejected Medlin's claim and accepted the IRS valuation of the parcels, which was based on values assessed for property tax purposes. The court decided the tax basis of the parcel sold was one-third of the total acquisition price of the three parcels, or $16,000 (one-third of $48,000). Thus, Medlin's taxable gain was increased by $8,000 ($24,000 less $16,000). In rendering its decision, the tax court emphasized that Medlin presented no records prepared at the time of the purchase or sale that reflected the allocation described in his testimony. To make matters worse, he had failed to report the sale on his income tax return.

As this case clearly shows, lack of proper documentation to support tax treatment can be costly. Consultation with a tax accountant or tax attorney is recommended.

Dr. Stern (stern@indiana.edu) is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

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Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
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800-244-2144 orders only

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.