

THE COHAN RULE: DEAD, OR ALIVE?
(TAXPAYER RECORD-KEEPING IN AN IMPERFECT WORLD)

W. Patrick Cantrell

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I. INTRODUCTION

- A. In civil tax cases, except as otherwise provided by statute, the general rule is that the taxpayer has the “burden of proof.” Burden of proof issues are beyond the scope of this presentation. Suffice it to say, however, that in disputed federal tax cases, if a taxpayer has no proof that his tax return is correct, the IRS’ determination is presumptively correct [See, e.g. Tax Court Rule 142(a)]

How does a taxpayer “prove” his case? By providing “records.” What kind of records suffice? Answer: For individuals, checks, receipts, invoices, correspondence, bank statements, “information” returns – essentially anything in writing. Additionally, businesses must provide “books” that can consist of ledgers, journals, spreadsheets, or any other kind of systematic way of recording and summarizing business transactions that lead to a trial balance that ties into a tax return.

RULE OF THUMB THAT TAX LAWYERS FOLLOW: DOCUMENTS ARE WHAT IT TAKES TO WIN DISPUTED TAX CASES.

Is verbal testimony of a taxpayer considered to be proof? **Yes**, despite the fact that IRS auditors will rarely accept it without documentary corroboration. But documents are obviously better.

- B. In spite of the general rule that requires a taxpayer to substantiate his deductions, a court may waive the requirement under certain circumstances. Under this rule of “indulgence” established by the “Cohan” rule [see case analysis below], when the taxpayer is unquestionably entitled to a deduction, but the amount is not adequately substantiated, the court will make an allowance based on an estimate.

The *Cohan* rule will not be applied where the taxpayer has access to evidence to support the deduction, but fails to produce the evidence, or where there is no evidence to support the fact of entitlement to the deduction.

The Cohan rule has been extended far beyond its original application, to such items as:

- Sales taxes
- Contributions
- Losses
- Purchase price of deceased partner’s interest
- Allocation of payments between non-compete covenant and goodwill

II. STATUTORY PROVISIONS

A. I.R.C. § 6001

Every taxpayer is required by law to keep such records as the IRS may from time to time prescribe. The record-keeping requirement pertains to substantiation of deductions, etc. as well as to determine whether a tax return is even required to be filed.

B. I.R.C. § 274(d) [“T&E” Rules]

In an expansion of the general rule [§ 6001], this provision states that when a taxpayer incurs expenses for travel, entertainment, gifts, or for “listed property,” no deduction is allowed unless the taxpayer substantiates by “adequate records” all of the following four elements:

- Amount of the expenditure,
- Time and place of the expenditure,
- Business purpose of the expense, AND
- Business relationship to the person entertained or receiving the gift.

C. I.R.C. § 280F(d)(4)

“Listed property” includes the following: (1) passenger automobile, (2) other means of transportation, (3) entertainment, etc. property, (4) [personal] computer or peripheral equipment, (5) cellular telephone, (6) other property prescribed by regulations.

III. REGULATIONS

A. General Rule

Taxpayers are required to keep such permanent books of account, or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown on tax returns. [Treas. Reg. § 1.6001-1(a)] However, it is not necessary that farmers and wage earners keep books of account with respect to income. [Treas. Reg. § 1.6001-1(b)] [QUERY: Does this effectively shift the burden of proof to the government when it comes to income?]

B. Period of Retention

Records should be retained so long as the contents thereof may become material in the administration of any internal revenue law. [Treas. Reg. § 1.6001-1(e)] Records are to be maintained for at least four years after the due date of such tax return for the return period to which the records relate, or the date such tax is paid, whichever is the later. [Treas. Reg. § 31.6001-1(e)(2)]

C. Form of Records

Records required shall be kept accurately, but no particular form is required for keeping the records, so long as the IRS can ascertain the correct tax liability. [Treas. Reg. § 31.6001-1(a)] [QUERY: Does this mean that a small business must maintain a perfectly balanced general ledger? Obviously not.]

D. Place for Keeping Records

Records are to be kept at a convenient and safe location, accessible to IRS agents and shall at all times be available for inspection by such officers. [Treas. Reg. § 31.6001-1(e)(1)]

E. Relief from § 274(d) rules

The regulations provide taxpayer with some relief from the harsh 274(d) rules:

- No receipts are required for non-lodging T&E expenses if they are < \$75.
- Records lost due to casualty may be reasonably reconstructed.
- If a § 274(d) element is missing, one can substitute other corroborative evidence.
- Records for a portion of a year can be used and extrapolated for the entire year using sampling techniques.

[Treas. Reg. § 1.274-5]

IV. CASE LAW

A. The Cohan case

George Cohan was a Broadway theatrical producer and playwright back in the 1920's. He testified at trial that he incurred substantial travel and entertainment expenses but kept no records. The Second Circuit held that the trial court should have allowed him some deductions as an estimate, even in the absence of records, because it was obvious that he spent something. [Cohan v. Commissioner, 8 AFTR 10552 (2nd Cir. 1930)]

B. The Williams Case

In refund litigation, the taxpayer received a \$500 per month expense allowance to entertain customers. He testified that he spent at least that amount for business purposes, but kept no records. The Fifth Circuit held that he did not sustain his burden of proof. The Fifth Circuit did not criticize the Cohan decision, but said only that the trial court has considerable latitude. [Williams v. Commissioner, 51 AFTR 594 (5th Cir. 1957)]

C. The Bell case

Landscaping business expenses can be estimated even though records were missing. Citing Cohan, the trial court said, "If a taxpayer establishes that he paid a deductible expense, but is unable to substantiate the precise amount, we may, after 'bearing heavily' upon the taxpayer whose inexactitude is of his own making, estimate the amount. We may do this only if we are convinced that the taxpayer paid such an expense and we have a basis upon which to make an estimate." [Bell v. Commissioner, TCM 2011-296]

V. OTHER ISSUES

A. Destruction of Records

Destroying records can result in criminal prosecution. [IRM 9.5.11.4.2 (2)] This is particularly important in collection cases like offers in compromise.

B. Electronic Records

Obviously business records are frequently, if not always, kept on electronic media. Upon demand, these records have to be produced, either in hard copy or via some kind of digital format. What if the IRS demands that a business produce an electronic report that is not normally produced in the ordinary course of business? They can't do that. [See Rev. Proc. 98-25, 98-1 CB 689]

And generally IRS cannot gain access to computer source codes.

C. No Records

What does the IRS do when the taxpayer has no records from which to determine his income? Answer: They can reconstruct taxable income using a variety of indirect means, including: net worth method, source and use of funds method, bank deposits method, bureau of labor statistics, etc. These indirect methods have been judicially approved over the years by many court decisions.

Can a taxpayer, who has lost or misplaced his records, reconstruct his own taxable income using an indirect means, or some kind of statistical analysis? Answer: Yes.

A determination by the IRS that a taxpayer's records are inadequate may result in the imposition of a negligence or civil fraud penalty.

D. Use of Statistics

Taxpayers may use statistical sampling procedures to support items on their tax returns. [Rev. Proc. 2011-42, 2011-37 IRB 318]

IRS permits the use of statistical sampling to determine which portion of T&E expenses are subject to the 50% disallowance rule. [Rev. Proc. 2004-29, 04-1 CB 918]

Bureau of Labor statistics can be used by the IRS to reconstruct income when a taxpayer has been uncooperative. [IRM 25.18.2.10] QUERY: Can a taxpayer use those same statistics when records are incomplete or missing? In my opinion, YES!

VI. CONCLUSIONS AND SUMMARY

- A. Don't assume that just because a client's records are imperfect, we cannot win a disputed tax case.
- B. There are many ways to defeat the government's presumption of correctness, particularly in an income issue.
- C. Statistical analysis is a useful tool in reconstructing a taxpayer's income. [BLS, RMA, experts]
- D. Verbal testimony (through the use of affidavits or live testimony) is an effective way to present evidence to the IRS or to a court that documents may not be able to explain. IRS auditors are often under the mistaken impression that verbal statements are not proof at all.