Tax Court Reminds Taxpayers That All Income Should Be Reported and Reinforces the Continued Validity of the *Cohan* Rule

By Jonathan Kalinski and Luke Ryan

In two recently issued decisions, the U.S. Tax Court reaffirmed the validity of the so-called "*Cohan* Rule" that allows the Court to estimate the amount of a taxpayer's deductible expenses so long as the taxpayer clearly shows that he or she incurred the expenses and the Court has a reasonable basis for making such an estimate. On December 28, 2023, and January 3, 2024, the Tax Court issued *Villa v. Commissioner*, T.C. Memo 2023-155, and *Alvarado v. Commissioner*, T.C. Memo 2024-1, both of which explained that, while the *Cohan* Rule may not be invoked to estimate expenses covered by the strict substantiation requirements of I.R.C. § 274(d), the Rule does allow the Court to estimate otherwise unsubstantiated costs of goods sold. The burden of proof, however, remains upon the taxpayer, and any inexactitude in the amount of unsubstantiated deductions will be held against the taxpayer.

I. The *Cohan* Rule

The *Cohan* Rule is named for the 1930s decision involving Broadway impresario George M. Cohan, *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), in which the Second Circuit ruled that a taxpayer may be allowed to deduct certain business expenses, in the absence of complete records of such expenses, if the taxpayer can provide some reasonable basis for estimating the expense amounts and can show that the expenses were incurred in the pursuit of the taxpayer's trade or business. "Absolute certainty in such matters is usually impossible and is not necessary," the Second Circuit explained. Accordingly, the Second Circuit's instructions require the Tax Court to "make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making."

To benefit from the *Cohan* Rule, the taxpayer must provide a reasonable basis for estimating the expenses by presenting evidence such as invoices, canceled checks, receipts, or other documentation, and the expenses in question must have a clear connection to the taxpayer's trade or business. In applying the Rule, the court may consider the credibility of the taxpayer's estimates and the circumstances surrounding the case when determining whether to allow deductions.

II. *Villa v. Commissioner*

In *Villa v. Commissioner*, the taxpayer, Mr. Villa, operated a fence-building business as a sole proprietorship, working as a subcontractor for a separate building company, All-Texas Fence, and as a direct contractor for his personal customers. Mr. Villa and his wife reported their income from All-Texas Fence on the couple's joint 2016 and 2017 tax returns, but they did not report income that Mr. Villa received from his direct contracting work. All-Texas Fence supplied Mr. Villa with the wood for his subcontractor projects, but he was responsible for all other costs, such as tools, labor, and transportation. For his direct contracting work, Mr. Villa had to pay out-of-pocket for both the materials and his other costs. Mr. Villa's cousin, who was not a licensed accountant, prepared the Villas' tax returns.

After selecting the Villas' returns for audit, the IRS conducted a bank deposits analysis and determined that the Villas' gross income for both years should be increased by the payments that Mr. Villa received for his direct contracting work. The IRS also imposed accuracy-related penalties.

Before trial, the Villas conceded the increases in their gross income for both years, but they asked the Tax Court to determine that Mr. Villa's net profits should be reduced by certain costs of goods sold based on evidence of cash withdrawals by Mr. Villa and an estimate of his average profit margin from his direct contracting work.

In deciding the Villas' case, the Court noted that "the reduction of gross receipts by cost of goods sold is mandatory (*i.e.*, not a matter of legislative grace), as only income is taxable under the Sixteenth Amendment." Turning to Mr. Villa's first method of proving his cost of goods sold—evidence indicating that he made modest cash payments to a fencing supply distribution company and large cash payments toward business-related accounts that he held at Lowe's and Home Depot—the Court allowed 50% of Mr. Villa's cash withdrawals because it was "clear . . . that a substantial portion of the . . . withdrawals represent material and labor costs."

Turning to Mr. Villa's second method of proving his costs of goods sold—using a sample direct contracting job as a basis for estimating the ratio between cost of goods sold and Mr. Villa's gross receipts—the Court was not persuaded to increase the Villas' deductible expenses by those amounts because the record was not clear whether such costs of goods sold already were included in the parties stipulated expense amounts. "[S]uch inexactitude will be held against the Villas under the *Cohan* rule," the Court explained.

Finally, the Court rejected the Villas' arguments against imposition of accuracy-related penalties because the Villas failed to report any of Mr. Villa's gross receipts from his direct contracting work and their reliance on Mr. Villa's cousin—who was not a professional tax advisor or accountant—to prepare their returns was unreasonable under the circumstances.

III. *Alvarado v. Commissioner*

Similarly, in *Alvarado v. Commissioner*, the IRS alleged that the taxpayer had certain federal income tax deficiencies and penalties that arose from unreported gross receipts and overstated costs of goods sold at the taxpayer's used car sales business. "A taxpayer is required to maintain sufficient permanent records to substantiate all components of reported net income, including cost of goods sold," the Court explained. "However, the Court may estimate cost of goods sold under a variation of the *Cohan* rule . . . even when cost of goods sold is not fully substantiated, provided that there is a reasonable basis for making such an estimate."

Applying the *Cohan* rule, the Court determined that the IRS had taken "the extreme position that many of the used cars sold in the years in issue had no inventory cost whatsoever." Accordingly, because the IRS's position would have led to implausible results, the Court declared that "the law does not require this bizarre result." Instead, the Court conducted a thorough analysis of the evidence that the taxpayer provided and his testimony at trial. While noting that the Court must "'bear heavily' on Mr. Alvarado for his failure to keep adequate records," the Court ultimately determined total costs of goods sold that were approximately $1 million more than what the IRS had determined.

Turning to the penalties that the IRS sought and whether the Service had introduced clear and convincing evidence that the taxpayer had an underpayment due to fraud, the Court stated:

> We now clarify that the *Cohan* rule (and its adaptation to cost of goods sold) contributes to determining—rather than merely estimating—the tax imposed by the Code for those

> taxpayers who do not keep (or at least do not furnish) adequate financial records. Therefore, the Commissioner has satisfied his burden of proof for the first element of fraud: There is clear and convincing evidence that Mr. Alvarado did not keep (or furnish) adequate records for [his business] and that he underpaid his income tax for both years in issue within the meaning of section 6664(a).

Nevertheless, because the Court's *Cohan* rule analysis "bore heavily" on Mr. Alvarado, and, the Court determined, it was just as likely that Mr. Alvarado's business had a negative net profit for the years in issue, the Court concluded that it lacked clear and convincing evidence that Mr. Alvarado actually knew that he owed more tax than he paid. Therefore, the Court explained, it would not find him liable for the fraud penalty under section 6663.

IV. Conclusion

The practitioner lessons in these cases are that the *Cohan* rule is alive and well after almost 100 years, and it encourages creative solutions to situations where substantiation is imperfect. Think outside the box for ways to utilize the *Cohan* rule. The Rule, however, will not save your client when you cannot establish a reasonable basis, and certainly will not help when strict substantiation is required. In addition, the taxpayer still bears the burden of proof, and the court will assess the reasonableness of the taxpayer's estimates and the taxpayer's credibility. Therefore, it remains advisable for taxpayers to maintain thorough and accurate records of their business expenses to minimize the risk of IRS challenges.

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