RIP & PAULA RIDGE 11782 S Main Street Trenton, GA 30752-2833,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 04-453
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER ON
TAXPAYERS' SECOND APPLICATION FOR REHEARING

This case involves final assessments of 1997, 1998, and 1999 Alabama income tax entered against the above Taxpayers. The Taxpayers failed to timely file Alabama returns for the subject years. The Department subsequently received IRS information indicating that the Taxpayers were subject to Alabama tax and should have filed returns in those years. It accordingly assessed the Taxpayers based on the IRS information. Rip Ridge ("Taxpayer") appealed.

A Preliminary Order was entered directing the Taxpayers to file returns for the subject years. A Final Order was entered on November 16, 2004 affirming the final assessments because the Taxpayers failed to file the returns as directed.

The Taxpayers' representative timely applied for a rehearing and submitted the returns.[1] The Department rejected the returns because the Taxpayers failed to substantiate the deductions claimed on the Schedule Cs submitted with the returns. The Schedule Cs related to the Taxpayer's construction business. The Taxpayer was directed to submit records substantiating the Schedule Cs.

[1] The 1997 return was a joint return. However, the Taxpayer filed individual 1998 and 1999 returns because the couple divorced in 1998.

The Taxpayer's representative responded that the records had been lost. He explained that the Taxpayers were having marital problems in 1997 and 1998, which led to their divorce in December 1998. The Taxpayer was in an accident in mid-1998, and consequently spent several months in the hospital and at home recuperating. Finally, the Taxpayer was arrested and incarcerated in May 2000. When he was released, his records for the subject years had been lost or destroyed.

The Taxpayer's representative determined his Schedule C expenses for the subject years based on his 1994, 1995, and 1996 returns. The expenses for those years were determined as a percentage of income reported in each year. That percentage was then applied to the income amounts for 1997 through 1999. The representative argues that the expense estimates should be accepted because the IRS and the Department accepted the Ridges' 1994 – 1996 returns as filed.

The Department refused to accept the representative's estimates because there were no records supporting the amounts. A Final Order on Rehearing was entered on April 13, 2005, which only slightly adjusted the amounts due. The Taxpayer's representative again applied for a rehearing, arguing that the Department should reasonably estimate the Taxpayer's Schedule C deductions based on the authority of *Cohan v. Commissioner*, 39 F.2d 540 (1930). The Department responded that the *Cohan* rule had been abolished, and that The Taxpayer's expenses could not be estimated.

The Taxpayer's representative responded by submitting some receipts for expenses incurred by the Taxpayer in 2004. He also requested that a hearing be conducted at which the Taxpayer could testify concerning his business expenses. A hearing was accordingly conducted on September 1, 2005. Jeff Patterson represented the Department at the

hearing. CPA Gerald Lee Clemmons represented the Taxpayer.

As indicated, the Department argues that the Taxpayer's Schedule C expenses cannot be allowed because he failed to provide records substantiating the expenses. The Department contends that the amounts cannot be estimated because the *Cohan* rule has been abolished. I disagree, at least concerning the continued validity of the *Cohan* rule.

The *Cohan* rule permits the trier of fact to allow a taxpayer some deductions in certain circumstances, even if the taxpayer fails to provide records proving the exact amount that should be allowed. The *Cohan* rule has been statutorily abolished concerning business-related travel, entertainment, and the other deductions covered by 26 U.S.C. §274. However, it is still viable concerning other types of deductions.

> The rule as announced in Cohan applied to travel and entertainment expenses. In that area, Congress has overruled the result in section 274(d), which imposes a heavy burden of substantiation on a taxpayer claiming deductions under section 162 for travel and entertainment expenses. But the Cohan principle was applied more generally and apparently survives where not legislatively overruled. See, e.g., *Cummings v. Comm'r*, 5 Cir. 1969, 410 F.2d 675, 679; *Green v. Comm'r*, 1980, 74 T.C. 1229, 1237; see generally 4A J. Mertens, Law of Federal Income Taxation s 25.04 (Doheny rev. ed. 1979).
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> > . . . (A) taxpayer would (otherwise) in every case be denied a deduction for otherwise allowable expenses where there was a failure of strict proof on his part. Thus, even though it is quite apparent that because of the nature of the taxpayer's business certain types of ordinary and necessary expenses would have to be incurred and were actually paid, nevertheless, if the taxpayer did not maintain adequate records, no part of such expenses would be allowable because proof of detail or itemization was lacking. Fortunately, however, such automatic disallowance has not been the general rule . . .
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> Id.
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> The Cohan rule does not in any way shift the burden of proof. Stated another way, it simply provides that the failure of the taxpayer to establish the exact amount to which he is entitled should not lead the court to ignore that the

taxpayer has met his burden of proof on his entitlement to some deduction.

Ellis Banking Corp. v. C.I.R., 688 F.2d 1376, 1383.

The *Cohan* rule was explained in *Trigon Ins. Co. v. U.S.*, 234 F.Supp. 581 (E.D. Va. 2002), as follows:

> Courts continue to rely on the *Cohan* rule, albeit with some caution, to estimate the amount of a claimed deduction in cases where the taxpayer is unable to produce evidence substantiating the exact amount of a claimed deduction. See e.g., *Dunn v. Comm'r*, 301 F.3d 339, 358 (5th Cir. 2002); *Ellis Banking corp. v. Comm'r*, 688 F.2d 1376, 1383 (11th Cir. 1982); *Levine v. Comm'r*, 324 F.2d 298, 302-03 (3d Cir. 1963); *Bryant v. Comm'r*, 76 F.2d 103, 105 (2d Cir. 1935). Nevertheless, courts also have been reluctant to accept invitations to follow *Cohan*, where a taxpayer fails to provide evidence that would permit an informed estimate of the amount of a deduction. See e.g., *Reinke v. Comm'r*, 46 F.3d 760, 764 (8th Cir. 1995); *Rodman v. Comm'r*, 542 F.2d 845, 853-54 (2d Cir. 1976); *Coloman v. Comm'r*, 540 F.2d 427, 431-32 (9th Cir. 1976).
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> For example, in *Coloman*, the Ninth Circuit explained the danger of liberal application of the *Cohan* rule. In that case, the taxpayer claimed a loss based on the depreciation of stock received in exchange for a partnership interest. The Taxpayer, however, could not establish the basis of the stock with any credible evidence, so the Tax Court denied the deduction. On appeal, the taxpayer urged the Ninth Circuit to reverse the Tax Court for failing to apply the *Cohan* rule, but the Court declined: "In the instant case, to allow the *Cohan* doctrine to be invoked by the taxpayers would be in essence to condone the use of that doctrine as a substitute for burden of proof." 540 F.2d at 431-32. For similar reasons, courts have declined to apply *Cohan* in cases where there is no doubt that the taxpayer incurred some deductible expense, but the taxpayer failed to present evidence sufficient to allow the court to make an accurate finding on the amount of the deduction. In *Williams v. United States*, 245 F.2d 559, 560 (5th Cir. 1957), a corporation brought a refund suit claiming a deduction for expenses that its president had incurred in entertaining potential customers. The corporation's Board of Directors had given its president an allowance for such expenditures, and, in its refund suit, the corporation simply claimed the amount of that allowance as the amount of the deduction. Although the District Court held that the corporation "doubtless did have certain entertainment and other expenses in 1950," it declined to estimate the amount of the deduction under *Cohan*. The Fifth Circuit affirmed, and explained that, although *Cohan* grants district courts the latitude to estimate in some circumstances, it "certainly does not require that such latitude be exercised." *Id.* Unless a district court has

> before it evidence sufficient to form a reasonable estimate, the Fifth Circuit explained, estimation under the *Cohan* rule "would be unguided largesse." *Id*.; see also *Norgaard v. Commissioner*, 939 F.2d 874, 879 (9th Cir. 1991); *Vanicek v. Commissioner*, 85 T.C. 731, 742-43, 1985 WL 15409 (1985). Following this reasoning, triers of fact consistently have declined to follow *Cohan* where the evidence is insufficient to form the basis of a reasonable estimate. See *Maguire v. Comm'r*, 1996 WL 123146, 71 T.C.M. (CCH), T.C.M. (RIA) 96,145 (U.S. Tax Ct. 1996); *Williams v. Commissioner*, 1994 WL 50426, 67 T.C.M. (CCH) 2185, T.C.M. (RIA) 94,063 (U.S. Tax Ct. 1994) ("We stress that in order for this Court to apply the rationale of *Cohan v. Comm'r* . . . to any particular disallowed expenditure, there must be sufficient evidence to permit us to make an estimation . . . Self-serving, vague, and undocumented testimony is insufficient."); *Hyde v. Comm'r*, 1992 WL 174208, 64 T.C.M. (CCH), T.C.M. (RIA) 92-419 (U.S. tax Ct. 1994); *Beam v. Comm'r*, 1990 WL 83346, 59 T.C.M. (CCH) 915, T.C.M. (P-H) 90,304 (U.S.Tax Ct. 1990).

Trigon Ins. Co., 234 F.Supp.2d at 589.

In this case, the Taxpayer certainly incurred some expenses relating to his construction business in the subject years. Unfortunately, he cannot produce records showing the amounts of the expenses. He presented evidence establishing the types of expenses he normally incurred in his business, but that evidence cannot be used to estimate the amount of the expenses incurred in the subject years.

The Taxpayer's representative determined the Schedule C expenses based on the amounts the Taxpayer claimed on his 1994, 1995, and 1996 returns. He argues that those estimated amounts should be accepted because the IRS and the Department accepted the prior years' returns. However, there is no evidence that the IRS or the Department ever reviewed the prior returns. Consequently, there is no indication that the deductions claimed on the prior returns were correct.

I sympathize with the Taxpayer, and his representative did the best job possible

under the circumstances. However, even under the *Cohan* rule that allows for some expenses to be estimated, there is not sufficient evidence from which the Taxpayer's Schedule C expenses in the subject years can be reasonably determined. Estimating the deductions based solely on the amounts claimed on prior, unaudited returns, without more, is not sufficient.

The tax and interest as finally determined by the Department is due to be affirmed. However, the penalties are waived for reasonable cause under the circumstances. The final assessments, as adjusted and less the penalties, are affirmed. Judgment is entered against the Taxpayers, jointly, for 1997 tax and interest of $4,223.52, and against the Taxpayer, individually, for 1998 and 1999 tax and interest of $1,433.41 and $161.48, respectively. Additional interest is also due from April 20, 2004. The April 13, 2005 Final Order on Taxpayers' Application for Rehearing is voided.

This Final Order on Taxpayers' Second Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered March 14, 2006.

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BILL THOMPSON
Chief Administrative Law Judge