WILLIAM F. BOLES 644 JAPONICA ROAD PRATTVILLE, AL 36067,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. INC. 06-272
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed William F. Boles ("Taxpayer") for 2001, 2002, and 2003 income tax. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on April 26, 2007. The Taxpayer and his attorneys, Gerald Hartley and Scott Speagle, attended the hearing. Assistant Counsel Mark Griffin represented the Department.

The Taxpayer failed to file Alabama income tax returns for 2001, 2002, and 2003. The Department received 1099 information from the IRS showing that the Taxpayer received income sufficient to require him to file Alabama returns for those years. Specifically, the Taxpayer received gross income of $103,097 in 2001, $109,282 in 2002, and $124,995 in 2003. The Department subsequently assessed the Taxpayer based on the IRS income information after allowing him a standard deduction and personal exemption in each year.

The Taxpayer is in his early 70's. He testified at the April 26 hearing that he has been in the business of hauling sheetrock, drywall, and other ceiling and wall materials for over 35 years. He routinely filed Alabama returns through 2000.

The Taxpayer suffered from several serious medical conditions from 2000 through 2003, which prevented him from actively operating his business. Specifically, he developed

a large growth on his head, which was surgically removed in 2000. He later had a hernia operation in 2001 or 2002, and a knee operation in 2002. Finally, he suffered a heart attack in January 2003. The Taxpayer's wife was also seriously ill and required continuous care from the Taxpayer during the subject years.

The Taxpayer uses four individuals to load, haul, and unload the sheetrock and other materials. He has always used a flatbed truck to haul the sheetrock. He also uses a pickup truck to transport two of the workers. He explained that when he was sick from 2000 until 2003, one of his long-time workers continued to operate the business for him. Unfortunately, the individual failed to keep records showing how much the workers were paid, or how much was spent for gas, maintenance, and other business-related expenses.

The Taxpayer concedes that he negligently failed to file Alabama or federal returns for the subject years. He explained that he was more concerned with his and his wife's health than with his business. However, after the Department or the IRS contacted him in 2003 concerning his failure to file, he immediately consulted with an attorney. The attorney advised him that he should begin keeping detailed records of his income and expenses. He did so. A reputable accounting firm subsequently prepared Alabama and federal returns for the Taxpayer for 2004, 2005, and 2006 using those records.

The Taxpayer's attorney also had a local CPA firm prepare the Taxpayer's returns for the years in issue. Because the Taxpayer had no records for those years, the returns were prepared based on the Taxpayer's 2004 through 2006 income and expense records. The Taxpayer's 2003 return reported a percentage of the income and expenses reported on his 2004 return. The Taxpayer's 2002 return was based on 80 percent of the income and expenses shown on the 2003 return. The 2001 return was based on 75 percent of the

income and expenses shown on the 2003 return. The Taxpayer contends that those returns should be accepted as a reasonable estimate of the Taxpayer's taxable income for the subject years.

All taxpayers are required to keep records from which their correct tax liability can be verified. See generally, Code of Ala. 1975, §40-2A-7(a)(1). A taxpayer claiming an income tax deduction must also provide records verifying the deduction, and in the absence of adequate records, the general rule is that the deduction must be disallowed. *U.S. v. Nipper*, 2003-1 U.S. Tax Case. (CCH) P50,408 (2003); *Peterson v. C.I.R.*, T.C. Memo 1995-212 (1995); *U.S. v. McMullin*, 948 F.2d 1188 (1991)

The Taxpayer's representatives concede that the Taxpayer failed to maintain records showing the amount of his business-related expenses during the subject years. They also concede that the 1099 income information received from the IRS is correct. They contend, however, that the Taxpayer should be allowed to estimate his business-related expenses based on the holding in *Cohan v. Commissioner*, 39 F.2d 540 (1930), i.e., the *Cohan* Rule.

The *Cohan* Rule provides that if a taxpayer is unable to prove the amount of an allowable deduction by exact records, the deduction may still be allowed if the taxpayer can present sufficient evidence from which the amount can be reasonably estimated. The *Cohen* Rule was discussed in *Ellis Banking Corp. v. C.I.R.*, 688 F.2d 1376 (1982), as follows:

> 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 Taxpayer in this case has hauled sheetrock and other construction materials for approximately 35 years. His method of operating has not changed over the years. He uses four individuals to load, haul, and unload the materials. He has always used a flatbed and a pickup truck in his business. The consistent nature of the Taxpayer's business requires him to incur substantially the same expenses for labor, fuel, vehicle maintenance, and other miscellaneous costs in each year. Those expenses remain approximately the same as a percentage of his income from year to year.

The Taxpayer maintained records of his business-related expenses in 2004, 2005, and 2006. Those records show that the Taxpayer's expenses averaged approximately 86 percent of his gross income in each year. Because the evidence establishes that the Taxpayer's expenses as a percentage of income remained approximately the same in each

year, and that he operated approximately the same from 2001 through 2006, the ratio of expenses to income in 2004, 2005, and 2006 should be accepted as a reasonable estimate of the Taxpayer's allowable expenses in 2001, 2002, and 2003.

The *Cohan* Rule is an extraordinary remedy that should be applied sparingly, and only when it is clear that the taxpayer has incurred deductible expenses and has presented sufficient evidence from which the expenses can be reasonably estimated. The Administrative Law Division has generally refused to apply the *Cohan* Rule, even in cases where business-related expenses were incurred, because there was not sufficient evidence from which a reasonable estimate of the amount of the expenses could be made. See, *Johnson v. State of Alabama*, Inc. 06-383 (Admin. Law Div. 2/15/2007); *Ridge v. State of Alabama*, Inc. 04-453 (Admin. Law Div. 3/14/2006); and *Shirley v. State of Alabama*, Inc. 96-153 (Admin. Law Div. 5/9/1996).

In this case, however, the Taxpayer undisputedly incurred labor, vehicle, and other expenses relating to his business. He presented evidence that the expenses were approximately the same from year to year. He also has reasonable, verifiable evidence concerning the amount of his expenses incurred in subsequent years from which his expenses in the subject years could be reasonably estimated. The *Cohan* Rule thus should apply.[1]

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[1] In *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App. 1980), the issue was whether a retailer that failed to keep records for the period in issue could establish his sales tax liability for the subject period using records from a test period outside of the subject period. The Alabama Court of Civil Appeals affirmed that the use of the test period records to establish the retailer's liability was acceptable:

> Using a test period in which adequate records were kept, the taxpayer's accountant was able to determine that 80% of the taxpayer's income was

(continued)

The Department is directed to recompute the Taxpayer's liabilities in the subject years based on the IRS income information, and allowing the Taxpayer expenses equal to 86 percent of the income. The Department should also include interest, plus the negligence penalty. The Department should notify the Administrative Law Division of the adjusted amounts due. A Final Order will then be entered.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered July 11, 2007.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Mark Griffin, Esq.
Gerald W. Hartley, Esq.
Joni Coman

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derived from tax exempt services. Although the time frame for the test period did not coincide with the years covered by the assessments, there was testimony that the taxpayer's business was substantially the same in both instances.

Ludlam, 384 So.2d at 1092.

Likewise, in this case, because the Taxpayer's business was substantially the same from 2001 through 2006, the "test period" of 2004 through 2006 can reasonably be used to determine the Taxpayer's expenses for 2001 through 2003.