R. GERALD & SHERRY G. PRESLEY P.O. BOX 1284 TALLADEGA, AL 35161-1284,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 07-644
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Gerald and Sherry Presley (jointly "Taxpayers") for 2000 income tax. Sherry G. Presley (individually "spouse" or "widow") appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a.[1] A hearing was conducted on December 4, 2009. CPA Grant McDonald represented the spouse. Assistant Counsel David Avery represented the Department.

Gerald Presley (individually "Taxpayer") was in the construction business and performed various construction related services, i.e., electrical work, painting, etc., before and during the year in issue. He operated his business as a sole proprietorship.

The Taxpayers filed short form 40A Alabama income tax returns in 2000 and prior years. They failed, however, to report the Taxpayer's construction-related business income on the returns. The Department received IRS information indicating that the Taxpayer had received income of $163,534.35 from Harley Davidson, Inc. in 2000. As indicated, the Taxpayers had failed to report that income on their joint 2000 Alabama return. The Department consequently assessed the Taxpayers for the additional tax due on the income, plus interest and the five percent negligence penalty.

[1] Gerald Presley died in 2003.

The Taxpayer's widow appealed the final assessment to the Administrative Law Division. She does not dispute that the Taxpayer received the 2000 income in issue from Harley Davidson. She claims, however, that most of the income was either nontaxable reimbursement for materials purchased by the Taxpayer, or was paid out to various subcontractors. She contends that those amounts should be deducted from the income, and also that she should be allowed to claim various other business-related expenses incurred by the Taxpayer in 2000.

Unfortunately for the spouse, her house burned in 2005, and she claims that all of the Taxpayer's business-related records were destroyed in the fire. The widow thus contends that the net income received by the Taxpayer from Harley Davidson must be reasonably estimated. For that purpose, her representative presented financial information from six relatively large contractors showing their net profit percentage. The 2000 net income from Harley Davidson based on that information was $27,528. The representative also used the source and application of funds method to determine that the Taxpayer netted $10,921 from Harley Davidson in 2000. Finally, the representative used an IRS informational chart concerning special trade contractors to show a net profit or income from Harley Davidson in 2000 of $38,103.

The Department attempted to compute the Taxpayer's net 2000 income from Harley Davidson using the invoices issued by the company to the Taxpayer. Those invoices show that the Taxpayer received gross income of over $163,000 from the company. The invoices included separately stated amounts for labor (electrical, carpenter, and/or miscellaneous labor) and materials. Based on the invoice amounts, the Department agreed to allow a reduction of one-half of the material charges and the average hourly rate for the

type of labor involved based on IRS estimates for the area.

The Taxpayers representative rejected the Department's computations because it did not allow for travel and other business-related expenses presumably incurred by the Taxpayer in 2000. He claims that the Taxpayer's business-related 2000 expenses can be reasonably estimated using the *Cohan* rule, see *Cohan v. Commissioner*, 39 F.2d 540 (1930), and that the information he submitted, i.e., the information from the six contractors, the use of the source and application of funds method, and/or the IRS information, should be accepted as the best estimate of the Taxpayer's true net income from Harley Davidson in 2000.

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 still survives 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.

> 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.

As indicated above, for the *Cohan* rule to apply, there must be sufficient evidence relating to the actual expenses/deductions incurred by a taxpayer from which a reasonable estimate of the expenses/deductions can be made. There is no such evidence in this case. Specifically, the various methods offered by the spouse's representative are based on unsupported estimates that are, except for the source and application of funds method, unrelated to the Taxpayers. And the source and application of funds method is based on unverified, and therefore unacceptable, estimates by the spouse.

The Department correctly recognized that the Taxpayer had some deductible expenses relating to his work at Harley Davidson in 2000. It consequently offered to allow the Taxpayers a deduction for one-half of the Taxpayer's materials relating to Harley Davidson and a portion of his labor. That allowance may be less than the expenses

actually incurred by the Taxpayer in 2000, but there is no way of knowing.

I sympathize with the Taxpayer's spouse, but if she and her husband had reported the income from Harley Davidson, and the corresponding expenses, on their joint 2000 return, the Department would have never received the IRS information showing that they had omitted the income from the return, in which case the Department in all likelihood would have never questioned the return. The spouse knew that the Taxpayer had worked at and received income from Harley Davidson in 2000, yet she signed the couple's 2000 joint return even though none of the income was reported on the return. In short, she bears some of the responsibility for the predicament she now faces.

The Department's offer to allow certain deductions is more than reasonable under the circumstances. The Department should recompute the Taxpayers' liability accordingly and notify the Administrative Law Division of the adjusted amount 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 December 15, 2009.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: David E. Avery, III, Esq.
Grant McDonald, CPA
Tony Griggs