PERSPECTIVE

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Dear IRS, Sorry, I Don't Have Receipts

By Robert W. Wood

If you understand anything about our tax system, it's probably that you must have receipts. In fact, it seems like heresy to suggest that everyone might not have to save all those pesky receipts to prove their tax deductions. We are trained from an early age to document everything, and that is especially true when it comes to taxes. In the tax world, "prove it" isn't simply a schoolyard bully's taunt. The IRS puts it much more professionally of course, asking you for "substantiation."

Substantiation is what the Internal Revenue Service asks for again and again to taxpayers who weren't diligent enough in saving their receipts. In fact, much of the IRS's correspondence audit program comes down to sending people letters requesting that they document their charitable contributions, employee business expenses, or other deductions--or have them disallowed. Having a system to document things and to stay organized is likely to save you headaches.

That's why it's so surprising to find a tax case that calls into question the age-old question that you must have receipts and documentation to prove your deduction. In fact, it's kind of refreshing to see that a court occasionally will push back. The case is Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930), and the taxpayer in question may not have had any receipts, but he seemed so, well, honest. The person who deserves thanks in this happy story is long-dead Broadway legend George M. Cohan.

When you think about Broadway, you may think of modern composers, playwrights, producers, and directors. But you'll need to reach considerably farther back in Broadway's history to thank the "burn the receipts" legend who's come back from the grave to help all taxpayers. Cohan was an early Broadway pioneer, author of such hits (and now classics) as "Give My Regards to Broadway" and "Yankee Doodle Boy." His grand old statue still commands Times Square.

But tax lawyers look to George M. Cohan for a different kind of legacy--an "I'll take you to court" audacity that is as American as apple pie. It's a shame that so few taxpayers have even heard of tax law's "Cohan Rule." Its genesis of the case is that Cohan had many of his show business travel and entertainment expenses disallowed by the IRS because he had no receipts. He was frantically busy, he argued, having little time to document his expenses.

The IRS panned his performance. So, Broadway's then baron took the IRS to court. First, he went to the Board of Tax Appeals, the predecessor to today's U.S. Tax Court. Predictably, the Board of Tax Appeals upheld the IRS—receipts, after all, are the stock in trade of a tax system! But Cohan appealed to the Second Circuit Court of Appeals, which in 1930 rocked the IRS back on its heels with a one-two punch. Judge Learned Hand would never accede to the Supreme Court, but his tax decisions remain luminary, and the Cohan case does not disappoint.

The Cohan Rule serves as an exception to stringent IRS recordkeeping requirements, allowing taxpayers everywhere to prove by "other credible evidence" that they actually incurred the expenses for deductible purposes. That's (deductible) entertainment. Cohan had incurred expenses for traveling and entertainment but didn't have receipts. So, he proved up his deductions by his testimony. That included his recollections and approximations of the amounts incurred, including cab and railroad fares, hotels, tips, restaurant, and other expenses for Cohan and his considerable entourage.

The Second Circuit believed him, and ruled in favor of Cohan. To be sure, the Cohan Rule doesn't always impress the IRS, and it doesn't always work in court either. It has been most classically applied in the case of travel and entertainment expenses. But theoretically, it could apply to virtually any item, so long as the item is not specifically subject to a heightened substantiation requirement under the code or regulations.

If the IRS is convinced by oral or written statements or other supporting evidence, and a reasonable approximation can be made, you may be entitled to the expense notwithstanding a failure to have it documented. For example, the Tax Court has applied the Cohan Rule to expenses for items such as a beauty consultant's license fee, gambling losses, qualified research activities, and the building and placement of signs. Does Cohan apply to charitable contributions?

One place where the Tax Court has been reluctant to apply the Cohan Rule is charitable deductions--or, at least it's been reluctant to do so since Congress passed strict substantiation requirements in 2006. Those rules require you to have a receipt even for small cash donations, including $20 put in the collection plate on Sunday and, for donations of more than $250, a contemporaneous written acknowledgement from the charity before filing your tax return.

For example, in Gomez v. Comm'r, T.C. Summary Opinion 2008-93, the Tax Court ruled against a couple who had written 10 checks tithing $6,100 to their church, even though the IRS itself didn't challenge the fact that they made the contributions. (The problem: They didn't have the written acknowledgement before filing their returns.) Moreover, the IRS noted that any written acknowledgement from a charity must not only include the amount contributed, but must also state whether the charity provided any goods or services in consideration for the contributions.

Then it must describe those goods or services and include a good faith estimate of their value. The Cohan Rule was followed in Ragassa v. Comm'r, T.C. Summ. Op. 2009-166 (Nov. 10, 2009). Mr. Ragassa had deducted $3,175 in charitable contributions. A devout member of the Ethiopian Orthodox Church, he attended church at least once a month, shuttling between parishes in Boston and Washington. He'd put about $100 in the collection plate each time he attended church, and he donated clothes too. Lacking receipts, he offered to give the IRS contact information so they could verify it.

No thanks, said the IRS. Echoing Judge Learned Hand's rebuke of the IRS in Cohan, the Tax Court said the IRS went too far in refusing to allow any deduction whatsoever to this honest soul. This taxpayer was an industrious individual working two jobs while attending school, the Tax Court noted. Plus, his religious commitment appeared to be genuine. Using its best judgment on the entire record--and being appropriately skeptical since Mr. Ragassa didn't have

documentation--the Tax Court found it credible that at least once a month throughout 2005, he attended church and made a cash contribution of at least $25 each time. That amounted to $300 for the year.

The Ragassa decision involved charitable contributions made during 2005, before Congress passed stricter substantiation requirements for charitable contributions in 2006. The Tax Court declined to give specifics on how it will apply the Cohan Rule to charitable contributions from 2006 forward, noting that it had yet to definitively decide whether the Cohan Rule is available to estimate charitable contributions. It did, however, cite existing precedent for applying the Cohan Rule where it finds the taxpayer to be candid, forthright, and credible.

Perhaps the Tax Court was hinting it would take a similar approach in the future. Cohan is no panacea, so keep those records. Of course, a $300 deduction is vastly less than half a loaf if you actually shelled out $3,600. That should cause you to take with a grain of salt Cohan's victory and the victory of souls like Mr. Ragassa who walk in Cohan's footsteps. Still, these crumbs can make a difference when you're dealing with IRS personnel who say no-receipt, no-deduction. Plainly, though, good receipts are far safer!

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*