

Tax Credits and the *Cohan* Rule

By Robert W. Wood • Wood & Porter • San Francisco

There is almost nothing more widely understood about our tax system than the notion that one must have receipts. Receipts for the tax man are even fodder for comedians. From Lucille Ball to Jerry Seinfeld to SATURDAY NIGHT LIVE, we laugh nervously at proving up tax deductions. Even so, to my knowledge no one has joked about the *Cohan* Rule made famous by Broadway impresario George M. Cohan.

In an early era of Broadway, George M. Cohan brought us *Yankee Doodle Dandy* and many other hits. Today, George M. Cohan may be mostly known to tax advisors as the namesake of a very important tax rule, despite the fact that few taxpayers even have heard of it. The genesis of the *Cohan* Rule is *G.M. Cohan*, CA-2, 2 USTC ¶438, 39 F2d 540 (1930).

Cohan had many of his show business travel and entertainment expenses disallowed by the IRS because he had no receipts. Yet Cohan actually succeeded in arguing that he was frantically busy, and had little time to document his expenses. He thus successfully challenged

stringent IRS recordkeeping requirements, proving by “other credible evidence” that he in fact had incurred the expenses and that in fact they were business related. Cohan proved up by his testimony (including his recollections and approximations of the amounts incurred) cab rides, tips and restaurant expenses for Cohan and his considerable entourage.

To be sure, the *Cohan* Rule doesn’t always impress the IRS, and it doesn’t always work. It is most classically applied in the case of travel and entertainment expenses. But theoretically, it could apply to virtually any item. If the IRS is convinced by oral or written statements or other supporting evidence, and a reasonable approximation can be made, you may nevertheless be entitled to the expense notwithstanding a failure to have it documented.

Who Knew?

The research credit provided by Code Sec. 41 has been controversial, particularly in recent years. In broad strokes, it allows a

generous credit for the costs of research that would typically need to be capitalized. It has spawned a cottage industry of accountants and lawyers who, generally on a contingent fee basis, help clients to claim the credit, usually on amended tax returns. It was therefore somewhat surprising to see the *Cohan* Rule dusted off and used by a taxpayer—and successfully used—in this context.

The Fifth Circuit applied the *Cohan* Rule to the research credit, and many taxpayers are sitting up to take notice. [See *United States v. Arthur McFerrin et ux*, Tax Analyst Document No. 2009-13123, 2009 TNT 101-15 (5th Cir. 2009).] In some ways, this decision is quite logical. After all, many of the disputes about the research credit involve substantiation.

In this case, McFerrin had owned three S corporations. He hired Alliantgroup LP to determine if he qualified for an increasing research tax credit. Based on what Alliantgroup provided, McFerrin amended his 1999 return in 2003, claiming a credit of \$472,092 plus interest. The government issued the refund but then later sued to recover it, claiming that the credits were unsubstantiated.

The U.S. District Court determined that the projects didn't qualify for the credit and that there were no records of hours worked on the various projects. The Fifth Circuit, however, was convinced by evidence that was not traditional receipts, invoices and payroll records. For example, one key piece of evidence involved a review of the minutes of meetings. In addition, the Fifth Circuit found that the District Court was unwilling to consider rough estimates given by employees years after the fact to substantiate the claimed credit.

The Fifth Circuit remanded the case, noting that the Tax Court should look to testimony and other evidence in determining a fair estimate. The Fifth Circuit admonished that this evidentiary examination should include the institutional knowledge of employees,

Privilege

The Fifth Circuit opinion in *McFerrin* is being widely cited for its discussion of Code Sec. 7525, Privilege and Tax Shelters. However, *McFerrin's* dusting off of the *Cohan* Rule is arguably more important. It may well turn the research credit back into something much more viable for many more taxpayers.

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