



But It Has to Be Something! Tax Court Penalizes Taxpayer for Sloppy Records

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Cohan Rule Applied to Large Entity

In the case of *Tyson Foods and Subsidiaries v. Commissioner*, T.C. Memo. 2007-188 the Tax Court held that Tyson Foods would not be able to depreciate nearly \$2,000,000 when the firm was unable to identify what made up those amounts. The Tax Court rejected the taxpayer's argument that, based on rule established in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir 1930), they should be able to claim at least a depreciation deduction for the amounts in question.

Cohan and Records

We've considered the *Cohan* case previously in these podcasts, but this illustrates that a taxpayer's level of sophistication can work against them in when asserting *Cohan* relief from the general requirements of §6001. That provision generally requires:

Sec. 6001 Notice or regulations requiring records, statements, and special returns

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title. The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a).

Reg. §1.6001-1(a) provides more specifically:

Sec. 1.6001-1 Records.

(a) In general.

Except as provided in paragraph (b) of this section, any person subject to tax under Subtitle A of the Code (including a qualified State individual income tax which is treated pursuant to section 6361(a) as if it were imposed by Chapter 1 of Subtitle A), or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

The exceptions at Reg. §1.6001-1(b) involve a more limited standard for farmers and wage earners that is not applicable in the case we are looking at today.

The *Cohan* case involved vaudeville entertainer George M. Cohan a person, it appears, who kept less than stellar records. Initially the Board of Tax Appeals (predecessor of today's Tax Court) disallowed the deductions in the entirety. However, the Second Circuit Court of Appeals overturned that ruling and held as follows:

In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following

fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence.

It is important to note that the specific items covered in *Cohan* (the travel and entertainment) are no longer available for a *Cohan* exception, since Congress specifically provided in §274 that absent various required records that no deduction would be allowed for various expenses, and travel and entertainment are two such expenses. But the general *Cohan* rule still applies to any items that Congress has not imposed a specific disallowance for failure to keep certain records.

What is important to note, though, is the phrase that notes the court in making reasonable estimates is entitled to bear “heavily if it chooses upon the taxpayer whose inexactitude is of his own making.” That has been expanded a bit to consider a taxpayers’ level of sophistication in deciding what amount of “blame” should be assigned to the taxpayer in making a *Cohan* allowance.

As well, the Tax Court also requires that there be a “basis for some allowance,” interpreting that phrase to require that there must exist at least some minimum bit of information from which the court could reasonably come up with an estimated amount for the allowance.

The City’s Subsidy and the Taxpayer’s Records

The case involves initially a frozen food manufacturer, Culinary Foods, Inc. After suffering a fire in their facilities, the entity eventually looked to rebuild and the City of Chicago offered to pay a \$5 million subsidy if the firm would build its new facility in a certain section of the city. Culinary Foods took the city up on this offer and signed on to construction its facility in that location.

Two months later, Tyson Foods purchased the stock of Culinary Foods in a transaction that was treated as an asset purchase for federal income tax purposes. Tyson allocated the purchase among various assets, but allocated nothing to the \$5 million subsidy receivable. When the funds were received from the City of Chicago, the accounting staff charged the payments against various expense accounts on the books of Culinary Foods, including one account labeled “TIF moving expenses” that ended up with a zero balance for the year in question.

Under examination, Tyson agreed that they should have allocated \$5 million of the purchase price to the amount receivable from the City of Chicago, and then charged the amounts received against that account as they were received, also reducing the amounts allocated to other assets in the acquisition.

When Tyson adjusted the classification of those \$5 million in payments received, the amounts were credited against various accounts as noted below:

Ref.	Check No.	Date	Amount	Account No.	Account Description
A	96737341	1-27-95	\$875,453.00	101565	Land-Contra (\$625,000)
				101900	Goodwill (\$250,453)
B	96767315	3-10-95	1,955,451.00	101226	TIF moving expenses
C	96878721	7-5-95	52,189.43	101226	TIF moving expenses
D	96960850	11-24-95	422,704.97	101226	TIF moving expenses
E	97039857	4-15-96	330,780.50	780946	Misc. other income
F	97039858	4-15-96	1,363,421.10	780946	Misc. other income
Total			\$5,000,000.00		

When those entries were changed to be charged back to the receivable, the question arose about the proper treatment of the amounts “left over” that were no longer offset. The IRS and Tyson could not agree on the proper treatment of the balance now showing in the “TIF moving expense” account—an account that previously showed a zero balance.

In the end, Tyson claimed that they should be able to, at the very least, depreciate \$2,007,640 of disputed expenses, while the IRS claimed that Tyson had not demonstrated what made up those expenses, and therefore it was not appropriate to allow any sort of deduction related to those items, even as part of a depreciable asset.

The Argument

The taxpayer stated its position as noted below in the opinion:

Petitioner's records are insufficient to determine the extent to which these expenses should have resulted in a reduction of otherwise allowable ordinary and necessary business expenses as contrasted with the reduction of otherwise allowable depreciation. However, at a minimum, under the well-established Cohan rule (*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)), petitioner is entitled to treat the entire \$2,007,640 as a capital expenditure depreciable over a five-year time period and to reduce its taxable income accordingly for the resulting additional depreciation deductions.

Note that Tyson is conceding that there are issues with their records—issues we'll look at in more detail below. But Tyson argues that regardless of that fact, they are *something* and under the Cohan rule they should be able to “drop back” to what the taxpayer claims is the least favorable treatment those amounts would have had if documented—as depreciable equipment now part of the plant.

The IRS disagreed with that treatment, and they argued:

Petitioner cavalierly relies on *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) to assert that the remaining expenses are deductible and thus this Court should allow a greater deduction than the \$1,800,354 already permitted by respondent. Petitioner bases this belief on the fact that because account 101226, of which petitioner alleges the remaining \$2,324,193 was credited, is labeled "TIF Moving Expenses," and because the TIF Subsidy was given in connection with Culinary, then all of the \$2,324,193 [now reduced to \$2,007,640] in dispute must represent moving expenses of food processing equipment for which petitioner is entitled to capitalize [the cost] over a five year time period. Petitioner has no evidence to substantiate this allegation.

The court notes that the IRS specifically is complaining that “the list of vendors contains no information regarding the nature of the expense or when within the calendar year 1995 the expense was incurred.” The Court goes on to note the IRS claims Tyson Foods “wants this Court to make a leap of faith without any corroborating evidence that the remaining amounts in issue were for the purchase, the installation, or the moving of equipment for use in Culinary's processing facility.”

Nature of the Records

The Tax Court notes that

Here there is evidence that certain payments were made and recorded. From that, petitioner asks us to conclude that the payments must have been either for deductible expenses or depreciable assets and that the expenditures that were made are attributable to a tax year before the Court.

The nature of that evidence will prove key to deciding this case, and that evidence was lacking in a number of specifics.

In Court, Tyson relied upon a listing and the testimony of an attorney involved in the acquisition to establish what had happened. The Tax Court summarized the nature of that evidence as follows:

The only evidence that petitioner produced in this regard was the list of vendors and amounts that were recorded in the moving expenses account and the testimony of David L. Van Bebber (Van Bebber), a lawyer involved in the Culinary acquisition who had reviewed the document and concluded that "This lists out certain third party vendors that I believe Culinary was utilizing or making payments to for goods or services." Van Bebber was familiar with some, but not all, of the vendors on the list. As to one, for example, he testified that "It could be line equipment. It could be freezing equipment. It could be any number of the different types of equipment that we utilize in the food processing business." Although he identified the nature of the business of certain of the vendors, the most he could say was:

Q [Petitioner's counsel] Do you have any views as to the nature of the invoices?

A Yes. I believe these invoices were for either the purchase, the installation, the moving of equipment for the processing facility, the new processing facility on Ashland Avenue.

No invoices were in the record or ever produced. On cross-examination, Van Bebber admitted that he was not involved in the accounting with respect to the TIF subsidy or the disputed expenditures.

The Court was not incredibly impressed with this demonstration, and noted as much.

Petitioner repeatedly refers to the list of vendors as a "contemporaneous record". But the list is, in effect, contemporaneous only with respect to the recording of amounts that went into account No. 101226. It is not contemporaneous in the sense that invoices, purchase orders, or journal entry explanations reflect the nature of the items purchased. The witness's speculation, based on familiarity with certain of the vendors, is not reliable evidence that the items paid for are deductible currently or over time through depreciation.

The accounting evidence that Tyson had was merely a listing of the journal entries that were made into the account, but no information on why those entries were made. The attempt to use the attorney involved in the acquisition to provide that "why" was not considered anywhere near adequate by the court, who noted that he was not involved in the accounting that generated those journal entries, and his "speculation" as to what these amounts might have involved simply wasn't good enough. As the court noted:

On a record in which it is established that erroneous accounting entries were made, we have no confidence that the expenditures were for the purpose claimed by petitioner. Thus, we conclude that petitioner has failed to satisfy its burden of proving that it is entitled to the disputed deductions.

Why So Tough?

To many of us accountants, it may initially seem to “make sense” that these debits were for something and would either have represented assets or expenses. So while we might be concerned that the records were so sloppy that we can’t tell for sure why these entries were made, we might be willing to accept there was likely “something” here that the City of Chicago had paid for.

However, the very fact that this was a large company with numerous accountants on staff effectively “raised the bar” for what was a reasonable amount of support. As the IRS noted:

Respondent emphasizes petitioner's status in the industry and its employment of in-house and outside accountants and tax preparers “who were well aware of the record keeping requirements of the Internal Revenue Code.”

The Tax Court agreed that since the accountants for the plaintiff seemed to be responsible for this situation where no records existed, and those accountants reasonably should have known of the importance of maintaining such records, the Court was not willing to use the meager information as sufficient on which to make a Cohan allowance.

The result might have been different for a small taxpayer without a large accounting staff—but, then again, we have to remember the Tax Court would need something on which to base its estimates. As well, in most small entities it likely would not have been nearly as difficult to “reverse engineer” what must have made up the entries in question and unwind them. Apparently that was simply not possible in Tyson’s case, perhaps simply due to the sheer volume of transactions that a large entity’s accounting system captures.