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# IRS Loses to Yankee Doodle Dandy

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George M. Cohan (1878–1942) is known to the public as the composer of classic songs like “Give My Regards to Broadway” and “You’re A Grand Old Flag.” To the entertainment business he is one of the legends of Tin Pan Alley and founders of ASCAP. However, to tax lawyers and accountants he is revered due to *Cohan v. Commissioner*, 39 F. 2d 540 (2d Cir. 1930).

Even though the Cohan rule is now over 80 years old, taxpayers still win with it, as occurred on May 13, 2013, in *Heinbockel v. Commissioner*, TC Memo 2013-125. We will review this factually interesting case. However, it is worth looking into the Wayback Machine (for you fans of *The Rocky and Bullwinkle Show*) to review how the composer of “Always Leave Them Laughing When You Say Goodbye” triumphed over the IRS.

The 1928 decision by the Board of Tax Appeals (a predecessor to the Tax Court) considered many issues. However, only the one involving business expenses has earned a place in history.

“The next issue is based on the [taxpayer’s] claims…for deductions for advertising, entertainment and traveling expenses. We can not doubt, upon the record, that petitioner was required to and did spend large sums of money in traveling and entertaining during the period January 1, 1921, to June 30, 1923. There are, however, two obstacles to the allowance of the claims which the record has failed to overcome. One is that the amounts claimed are bare estimates unsupported by any vouchers or bookkeeping entries…. The other

is that we do not know what part of the amounts expended were for personal expenses. In these circumstances we can not say that the [IRS] erred in disallowing the deductions…."

The song and dance man appealed. The legendary Judge Learned Hand's "handling" of the business expense issue is short enough to quote in full:

"In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds…critics. He had also to travel much…. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial…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…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….. It is not fatal that the result will inevitably be speculative; many important decisions must be such."

Now, if we take the time machine ahead to the 2013 case, the Heinbockels' activities were unfortunate: chartering an airplane; grape farming; and a personal shopping service. The court quickly dismissed the claims that the plane chartering and grape framing were for-profit activities.

The court then described how Internal Revenue Code Section 274 imposes strict substantial requirements on some expenses, such as gifts, travel, meals and entertainment, and does not allow "the *Cohan* doctrine to estimate expenses." As to car expenses, the court disallowed those not allowed by the IRS despite Mrs. Heinbockel's testimony, ripped straight out of *The Real Housewives of Atlanta*: "If you understand my business and the marketing involved, you will pretty much see that I'm marketing myself 24-seven and I use that car for everything to do with the business. I'm constantly dropping off clothes, you know, advertising my business, because I'm a walking, talking testimonial [of] who I am."

As for travel, meals and entertainment, the Section 274 regulations provide that if a taxpayer is not able to substantially comply with the strict substantiation requirements, the taxpayer may establish by her own statement "containing specific information in detail as to such element" and "other corroborative evidence sufficient to establish such element." So the court was willing to listen to "credible testimony." This is, in effect, a *Cohan* approach. However, Mrs. Heinbockel was not as credible as George M. Cohan. For the Santa Barbara trip, Mrs. Heinbockel testified about the dinner at Senor Lucky's. Unfortunately, Senor Lucky's is in Santa Fe (which does not speak well for the lawyer who prepared her for trial). The Santa Fe trips, allegedly to check out hot new designers, always coincided with Mr. Heinbockel's birthday.

However, when it came to the personal shopping service's taxable income, the taxpayers struck *Cohan* gold. At trial the taxpayers claimed a $40,000 loss for 2005 compared to the $8,000 profit on their return. This was due to a large increase in the cost of goods sold. Mrs. Heinbockel had relied on a babysitter who was "also…just learning QuickBooks" to keep track of her records. Mrs. Heinbockel cited "a mishmash of QuickBooks entries, credit-card statements, bank statements, invoices and the occasional receipt…." However, the court used the *Cohan doctrine*, and gave her testimony weight, to grant a higher cost of goods sold than the IRS allowed, saving the Heinbockels a great deal of tax.

The lesson for practitioners is, of course, nothing new: we should try to instill in our clients a respect for the recordkeeping rules. However, the lesson for the IRS is that taxpayers can still sometimes tap dance their way to victory.

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