

The *Cohan* Rule and Research Credit Claims: Testimony As Evidence Establishing the Amount of Creditable Expenditures

By Leonard “Jay” C. Hite*

Leonard “Jay” C. Hite discusses application of the *Cohan* Rule to Code Sec. 41 research credit claims and the circumstances in which the *Cohan* Rule may provide an additional level of support for establishing the amount of qualified research expenditures (QREs).

I. Introduction

The Research Credit is a boon for taxpayers that conduct their research activities domestically and, unsurprisingly, is an area of particular interest to the IRS. Accordingly, Research Credit claims on amended tax returns have been designated a “Tier 1” issue by the IRS thus subjecting them to a high level of scrutiny and making complete contemporaneous documentation of establishing creditable costs essential to the sustainability of credit claims. In light of this, taxpayers are best served by maintaining thorough and complete supporting documentation that perfectly reflects the occurrence, nature and precise amount of every cent claimed.² The reality is, however, that perfect documentation is not always maintained by taxpayers. Does that mean that the Research Credit is categorically unavailable to those taxpayers?

This article discusses the potential applicability of the *Cohan* Rule to Code Sec. 41 research credit claims.³ Specifically, this article provides an analysis of the circumstances in which the *Cohan* Rule may provide an additional level of support for establishing

the amount of qualified research expenditures (QREs) through credible testimony when contemporaneous records establishing the precise amount of QREs is less than perfect. This is by no means an assertion that the *Cohan* Rule is an accepted alternative to the established documentation requirements for research credit claims. However, the *Cohan* Rule may offer a level of comfort for the use of credible testimony to establish the amount of QREs in situations where the precise amount of QRE is not certain, but the occurrence and nature of those QREs is conclusively established through contemporaneous documentation pursuant to the Research Credit substantiation requirements.

II. Analysis and Observations

A. Key Variables

The *Cohan* Rule refers to the holding in the 1930 Second Circuit Court of Appeals decision in *G.M. Cohan*,⁴ which allowed for an estimation of the amount of deductible expenses where records demonstrating the occurrence and amount of those expenses were unavailable. Specifically, the court determined that the earlier Board of Tax Appeals’

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disallowance of taxpayer's business expenses was inappropriate based on the taxpayer's credible testimony, which sufficiently established the occurrence of the expenditures and allowed for the estimation of the precise amount of those expenditures and corresponding deduction.⁵

Since the ruling in *Cohan* over 70 years ago, taxpayers have often invoked its holding as a means of overcoming expense substantiation issues stemming from less than perfect recordkeeping, with varying degrees of success. Paul G. Schloemer, in his article, *Cohan Rule Still Secures Some Deductions Despite Statutory Limits*,⁶ references six of the most recent regular Tax Court cases invoking *Cohan*⁷ and analyzes five of those cases.⁸ In reviewing these and other tax cases, it is possible to glean insight into the minimum documentation standards necessary to achieve at least a partial deduction of (or credit for) expenses claimed when a taxpayer lacks recordkeeping procedures that capture complete information to support its position.

In reviewing the recent cases issued as regular Tax Court decisions in which taxpayers invoked the *Cohan* Rule, Schloemer's analysis identifies two key variables that are essential, but not necessarily sufficient, for securing a discretionary estimation under *Cohan*:

- Some level of contemporaneous documentation; in conjunction with
- Credible corroborating testimony⁹

Successful cases have been those in which the taxpayer had some level of documentation establishing the occurrence of the claimed expense in conjunction with testimony that the court found to be credible with respect to the nature of the expense and its proximity. A common theme that proved fatal to attempts to invoke the *Cohan* Rule: cases in which the testimony offered by taxpayers was deemed to be questionable and thus could not be relied upon by the court to determine the nature of expenses. Similarly, taxpayers that cannot produce any contemporaneous supporting documentation establishing the occurrence of a claimed expense have been unsuccessful.¹⁰

B. Application to Research Credit Claims

The evidentiary standards for establishing QREs are defined in the 2004 final Research & Development Regulations:

Recordkeeping for the research credit. A taxpayer claiming a credit under section 41 must retain

records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see § 1.6001-1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.¹¹

Pursuant to the above, the record retention requirements for research credits are no different than the general requirements of Reg. §1.6001-1, which states in pertinent part that taxpayers "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."¹² Accordingly, it is imperative that taxpayers maintain sufficient books and records that establish the occurrence, nature and, to the best of their ability, the amount of creditable expenditures.

Cases invoking *Cohan* for purposes of estimating QRE confirm the key variables necessary to apply the *Cohan* Rule to the estimation of QRE in research credit claims. In *E.V. Fudim*,¹³ the taxpayer claimed a research credit but lacked contemporaneous records demonstrating the amount of time and corresponding qualified wage expenses were incurred. In addition, the taxpayer did not produce contemporaneous records demonstrating the amount of the claimed qualified supply costs. The court looked to contemporaneously published articles by the taxpayer regarding his research work as well as his educational background and patents obtained during the credit years to conclude that he had indeed conducted qualified activities.¹⁴ Based upon that information, the court estimated, pursuant to *Cohan*, that the taxpayer and his wife (who engaged in direct support to the research activities) spent 80 percent of their time respectively on qualified activities, and thus, 80 percent of their taxable wages for the credit years were creditable expenses.¹⁵ The key in this instance was the availability of some level of documentation evincing research, namely research articles published by the person producing QREs, patents, *etc.*, coupled with the otherwise credible testimony of the taxpayer regarding the activities.

Conversely, in *N.E. Eustace*,¹⁶ the court declined to estimate the amount of qualified expenditures because the taxpayer had failed to produce any records

demonstrating that the underlying activities met the requirements for qualification under Code Sec. 41. Specifically, the court determined that, within the overall research projects that were claimed, there may have been some sub-level of qualified activity; however, since no documentation could be produced to confirm the occurrence and allocation of qualified activities, the court could not perform an estimate.¹⁷ Similarly, in *Research Inc.*,¹⁸ taxpayer's claims were denied for failure to produce any documents evincing the occurrence of claimed QREs during the 1984–1989 base period.

Based upon the research credit cases invoking *Cohan*, the substantiation requirements under Code Sec. 6001, Reg. §1.6001-1 and the Research Credit Audit Techniques Guide (RCCATG) released in May of 2008, there are minimal standards that must be satisfied in order to argue for the application of the *Cohan* Rule for purposes of using testimony to estimate QREs. These standards are discussed in the following paragraphs.

1. Documentation

In order to sustain a testimonial estimation of allocable expenses under the *Cohan* Rule, the occurrence of in-house research wages paid to employees must be established through some level of contemporaneous records. This should include, at a minimum, payroll records establishing payment and employment coupled with a level of contemporaneous data, preferably at the project level, that demonstrates satisfaction of the requirements (four-part test) for qualification under Code Sec. 41 and commemorating individual employees' participation in the activities/project. In *Fudim*, articles the taxpayer had written contemporaneously regarding his research, patent documentation and educational background were used for purposes of establishing the occurrences of qualified activities and the existence of creditable wages. On the other hand, in *Eustace*, the taxpayer failed to demonstrate such facts to the court's satisfaction.

For qualified supply and contract research costs, at a minimum, contemporaneous records demonstrating the occurrence of the costs, such as a general ledger containing item descriptions, must be available. In addition, records, such as invoices that provide an indication of the payments and the nature of the supplies purchased or services provided should be available. In *Tyson Foods, Inc.*,¹⁹ ledger entries and a vendor list were

deemed insufficient, on their own, to demonstrate the nature of the occurrences in order for the court to agree to an estimation of deductible expenses under *Cohan*.

2. Testimony

In addition to documentation establishing the occurrence of the activities and the wages paid for qualified activities, credible corroborating testimony can be used to bolster and confirm the conclusions reached based on the contemporaneous records. This may facilitate the estimation of time spent by individuals, and corresponding QRE levels, associated with qualified activities.

The IRS has addressed the use of testimony to establish the amount of QREs in the RCCATG. With respect to testimony, the RCCATG states that "[t]he extent of the taxpayer's reliance on oral testimony and/or estimations, and not documentation, will also heavily impact on how you should proceed. You should consider whether oral testimony was from employees who actually performed the qualified research and how much time elapsed between the research and the testimony."²⁰ Accordingly, testimony is considered valid to the extent that it is credible. Credibility is a function of whether the person providing the testimony conducted the activities claimed, and the amount of time that has elapsed between the conduct of the activities and the testimony. Thus, testimony should be obtained from individuals with first-hand knowledge who conducted the claimed activities, and testimony should be obtained soon after the occurrence of the activities. In addition, the RCCATG discusses *Cohan* in the context of *Eustace*, and makes clear that testimony is not a means for establishing the occurrence and nature of QREs.²¹

It is important to note that the IRS has also acknowledged testimony as valid evidence not only in the RCCATG, but also in its own INTERNAL REVENUE MANUAL, which states:

The Internal Revenue Code requires all taxpayers to keep adequate records. There are times, due to unusual circumstances, when records do not exist. In such cases, oral testimony may be the only evidence available. Therefore, oral statements made by taxpayers to examiners represent direct evidence which must be thoroughly considered. Although self-serving, uncontradicted statements which are not improbable or unreasonable should not be disregarded. The degree of

reliability placed on a taxpayer's oral statements must be based on the credibility of the taxpayer and surrounding circumstantial evidence.²²

Examiners will exercise sound judgment to make reasonable determinations. The practice of disallowing amounts claimed because there is no documentary evidence available, which will establish the precise amounts beyond any reasonable doubt (even though it is clear that the taxpayer did incur some expense) ignores commonly recognized business practice, as well as the fact that proof may be established by credible oral testimony.²³

However, again, testimony alone will be insufficient to establish the occurrence of qualified activity and associated creditable wages without some documentation. Further, with respect to supplies and contract research, the documentation offered should establish the occurrence and nature of the costs, and testimony can then be used to corroborate and further bolster the claimed costs. However, as *Tyson Foods Inc.* demonstrated, courts will not apply the *Cohan* Rule

when documentation is coupled with testimony that is deemed not to be credible.

III. Conclusion

Under no circumstances should a taxpayer forego its efforts to maintain thorough documentation substantiating its research credit claims in reliance on the *Cohan* Rule, as it is clear that the *Cohan* Rule will not fill the void left by insufficient documentation. However, when the occurrence of qualified activities, the nature of these activities, and the related expenses can be adequately demonstrated with contemporaneous documentation it is consistent with the documentation standards articulated in Code Sec. 41, Reg. §1.6001-1, the INTERNAL REVENUE MANUAL and the RCCATC to conclude that the *Cohan* Rule provides a further basis for the use of credible oral testimony for purposes of estimating the precise amount of expenses allocable to the activities. Such testimony must come from individuals with first-hand knowledge that conducted the activity, and should be obtained soon after the occurrence of the activity.

ENDNOTES

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² See 2007 TNT 66-55. See also Leonard "Jay" C. Hite, *U.S. Export Controls and the Research & Development Tax Credit: Tax Professional Beware!* forthcoming TAX NOTES, Feb. 9, 2009.

³ All references to section refer to the Internal Revenue Code ("the Code") of 1986, as amended, and the regulations thereunder.

⁴ *G.M. Cohan*, CA-2, 2 USTC ¶489, 39 F2d 540 (1930).

⁵ *Id.*, at 544.

⁶ Paul G. Schloemer, *Cohan Rule Still Secures Some Deductions Despite Statutory Limits*, 81 PRACTICAL TAX STRATEGIES 1, at 91 (Aug. 2008) (hereinafter "*Cohan* Article").

⁷ The six cases issued as regular Tax Court decisions between 1998 and 2008 were *C.A. Boyd*, 122 TC 305, Dec. 55,625 (2004); *D.L. Baker*, 122 TC 143, Dec. 55,548 (2004); *F.J. Mendes*, 121 TC 308, Dec. 55,372 (2003); *D.J. Lychuk*, 116 TC 374, Dec. 54,353 (2001); *J.D. Shea*, 112 TC 183, Dec. 53,318 (1999); and *D.E. Conway*, 111 TC 350, Dec. 53,010 (1998).

⁸ Schloemer's analysis focuses on five of the above six cases since the *Cohan* Rule was ultimately found to be inapplicable to the expenses in question in *Boyd* because the expense substantiation requirements were specifically governed by statute.

⁹ *Cohan* Article, *supra* note 4, at 95.

¹⁰ *Id.*

¹¹ T.D. 9104, IRB 2004-6, 406.

¹² Reg. §16001-1(a).

¹³ *E.V. Fudim*, 67 TCM 3011, Dec. 49,867(M), TC Memo. 1994-235.

¹⁴ *Id.*, at 10.

¹⁵ *Id.*

¹⁶ *N.E. Eustace*, 81 TCM 1370, Dec. 54,280(M), TC Memo. 2001-66, *aff'd on other grounds* (without citing *Cohan*), CA-7, 2003-1 USTC ¶50,133, 312 F3d 905.

¹⁷ *Id.*

¹⁸ *Research Inc.*, Civ. No. 3-94-3, 1995 WL 560140 (D. Minn. June 21, 1995).

¹⁹ *Tyson Foods, Inc.*, 94 TCM 56, Dec. 57,005(M), TC Memo 2007-188.

²⁰ RCCATG, at 10.

²¹ *Id.*, at 5.

²² INTERNAL REVENUE MANUAL, §4.10.7.3.2 (Jan. 1, 2006).

²³ INTERNAL REVENUE MANUAL, §4.10.7.4.2 (Jan. 1, 2006).

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