TAX UPDATE

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A Yankee Doodle Dandy-and A Lousy Recordkeeper-the Cohan Rule

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Record Keeping

We all end up with clients with less than perfect records, so this week we'll look at both the historic *Cohan* case and a recent case where a court declined to use the rule established in *Cohan* to allow the taxpayer undocumented deductions.

The IRC requires that taxpayers keep adequate records. §6001 provides:

> 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).

Regulation 1.6001-1 clarifies this slightly:

> §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.
>
> (b) Farmers and wage-earners. --Individuals deriving gross income from the business of farming, and individuals whose gross income includes salaries, wages, or similar compensation for personal services rendered, are required with respect to such income to keep such records as will enable the district director to determine the correct amount of income subject to the tax. It is not necessary, however, that with respect to such income individuals keep the books of account or records required by paragraph (a) of this section. For rules with respect to the records to be kept in substantiation of traveling and other business expenses of employees, see §1.162-17.
>
> (c) Exempt organizations. --In addition to such permanent books and records as are required by paragraph (a) of this section with respect to the tax imposed by section 511 on unrelated business income of certain exempt organizations, every organization exempt from tax under section 501(a) shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts and disbursements. Such organizations shall also keep such books and records as are required to substantiate the information required by section 6033. See section 6033 and §§1.6033-1 through -3.
>
> (d) Notice by district director requiring returns, statements, or the keeping of records. --The district director may require any person, by notice served

> upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under subtitle A of the Code, including qualified State individual income taxes, which are treated pursuant to section 6361(a) as if they were imposed by chapter 1 of subtitle A.
>
> (e) Retention of records. --The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law

However, a key question becomes—what if taxpayers don't keep these records? The *Cohan* case dealt with these issues.

Cohan deals with income from 1919 (so it goes back a ways) and is a Second Circuit decision that reversed the decision of the Board of Tax Appeals (predecessor to the Tax Court) that a failure to keep records meant there was no deduction allowed. The court held that if it was clear that deductions had been sustained, they could be estimated if there was sufficient evidence to allow such estimation. That is, failure to follow the recordkeeping requirements did not impose draconian results.

However, there are significant limits imposed by the courts on when *Cohan* may be used. A recent case (*Butler v. Commissioner*, TC Summary 2006-39) deals with a case where the taxpayers had insufficient records to substantiate their claimed deductions.

Cohan Case

[2 USTC ¶489]George M. Cohan, Petitioner, v. Commissioner of Internal Revenue, Respondent

(CA-2), United States Circuit Court of Appeals for the Second Circuit, No. 114, 39 F2d 540, Decided March 3, 1930

Arthur F. Driscoll and O'Brien, Maleninsky & Driscoll, all of New York City (Holmes, Brewster & Ivins, of Washington, D. C., of counsel; Frank B. Meseke, of New York City, on the briefs), for petitioner. G. A. Youngquist, Asst. Atty. Gen., and Sewall Key, Andrew D. Sharpe, and Randolph C. Shaw, Sp. Assts. Atty. Gen. (C. M. Charest, Gen. Counsel, and Allin H. Pierce, Sp. Atty., Bureau of Internal Revenue, both of Washington, D. C., of counsel), for respondent.

Before L. HAND, SWAN, and MACK, Circuit Judges.

L. HAND, Circuit Judge:

In the year 1918 Cohan was a theatrical manager and producer, doing business in partnership with one, Harris. He had originally been an actor like his father and mother, with whom while a boy he had begun to act in vaudeville. After 1899 the parents with their two children, Cohan and his sister, divided their earnings, one quarter to each of the children and a half to the parents, the petitioner collecting for all and distributing. In that year they employed a manager and after his death another, who married the daughter in 1905 and with her left the group. The other three then employed Harris as their manager, and made a change in the distribution. Cohan had begun to write plays, on which he was getting royalties, which he first withdrew from the net earnings. The parents next took out five hundred dollars a week, and the four divided what was left, half to Harris, a quarter to Cohan, and the rest to the parents. Before 1914 Cohan and his father had left the stage and spent their time in directing their plays, until the father died on July 31, 1917.

On his father's birthday, in January, 1914, Cohan as an expression of affection wrote a letter to him, the only relevant parts of which declared that the two were, and had for years been, partners in all Cohan's enterprises. The mother had left the stage and was not engaged in helping her son when the father died. Shortly afterwards Cohan told her that his father's estate "was to be hers, that he wanted her to remain interested in their business affairs and that these affairs would be conducted as they had been in the past." Thereafter he always divided equally with her his profits from the firm of Cohan & Harris, as he had done with his father. On June thirtieth, 1920, he and Harris separated and Cohan continued alone, continuing to give her half his net profits.

The first question is whether upon the foregoing facts the Board was right in fixing Cohan's income as the whole of what he received from the firm of Cohan & Harris, while it lasted, and later as the whole of his own profits. He maintains that his mother was always his partner, and that he is entitled to deduct from his receipts the sums which he paid to her. If the father was a partner at the time of his death, that partnership ended and Cohan, the survivor, had to account to the legatees or next of kin. We do not know whether there was a will, but we may assume that there was none, as no mention is made of one. If so, the widow and each child took a third, but we are left in the dark as to what were the assets. They could not have included those of the firm of Cohan & Harris, of which the father was not a member, because although he helped Cohan in writing his plays, there is nothing in the findings to show that Harris was privy to this, or that he recognized him as an associate. The assets of the supposed firm of Cohan & Cohan were not therefore shown to have been more than such profits as might come to hand out of Cohan's share from Cohan & Harris, and of these the daughter had a third. Therefore, when Cohan told his mother that his father's estate "was to be hers", at most he did no more than increase her share of his undistributed profits from one to two thirds. There is no evidence that any part of these entered into his income for 1918, and the later years; or if so, what that part was. The petitioner has therefore on any theory failed in his proof pro tanto.

Moreover, he did not create a new partnership between himself and his mother at the same interview. The relevant law of New York at the time was Section two of the Partnership Law of 1909, which defined a partnership as "an association * * * of two or more persons who have agreed to combine their labor, property and skill, or some of them, for the purpose of engaging in any lawful trade or business, and sharing the profits and losses as such between them." In October, 1919, the Uniform Partnership Act became a law in New York, the definition in Section ten of which is: "An association of two or more persons to carry on as co-owners a business for profit." "Combine" in the first act is probably the equivalent of "co-owners" in the second, and it is difficult to see any substantial difference between the two. At any rate it is clear that neither Cohan nor his mother intended to carry on a joint business, for it does not appear that she had the least direction of his affairs, or any part in the conduct of the business. What he apparently meant was to give her half his earnings in consideration of his filial affection for her, and for her assistance in his early unprosperous years. However this unusual gratitude may affect our estimate of his character, we have only to consider whether he had changed his legal rights. There can be no doubt that he remained always free to stop his payments, and that her share depended on the endurance of his feelings toward her.

The Uniform Partnership Act has been similarly understood in New York, (*Morton* v. *Peyton,* 246 N. Y. 213), and elsewhere, (*Giles* v. *Vette,* 263 U. S. 553, *In Re Hoyne,* 277 Fed. Rep. 668, (C. C. A. 7); *In Re Williams,* 297 Fed. Rep. 696 (C. C. A. 1)), though none

of these decisions are in point upon the facts. It has much changed the common-law, even if the equivocal decision of *Cox* v. *Hickman,* 8 H. L. C. 267, be accepted as controlling in this country. While it still remains true under Section eleven that profit-sharing is prima facie evidence of the "association" defined in Section ten, we are not to understand that it is ever more. The later subdivisions of that section deny to it any probative effect in the situations defined, but do not under any circumstances make profit sharing ventures partnerships when it is otherwise apparent that the parties did not intend to "carry on as co-owners" any business whatever. The law has no doubt been brought into accord with business usage, yet there is not, as there should not be, any standard other than that the parties shall enter upon a joint business venture, vague as that is.

While the point is not argued, it is theoretically possible to debate whether the transaction was a transfer of one-half Cohan's rights in Cohan & Harris and later in his own business, though it did not create a partnership. In any such aspect it must be remembered that the attempt was not to give her any direct interest in the firm of Cohan & Harris, or if it was, it was ineffectual, because of Harris's failure to assent. Cohan could have given her no present right in such profits as he might thereafter withdraw, and there could not be an immediate gift, even if present words of gift had been used. Whether such a gift would have inured to the benefit of the donee as soon as Cohan withdrew any profits, and before he paid them over, we need not say; the gift was revocable until then in any case, and the case falls within *Mitchell v. Bowers,* 15 Fed. (2d) 287 [1 USTC ¶193], (C. C. A. 2), where the agreement contained an express power of revocation. Finally, the words were not those of present gift in any event, but at most only a promise to share with his mother as the profits come in, and this is equally true after the firm of Cohan & Harris was dissolved as before.

The next question is as to certain royalties upon a play produced in 1910, called "Get Rich Quick Wallingford." Cohan had written this in collaboration with his father who contributed the fourth act. As joint authors, each had a share in the resulting property, (*Maurel* v. *Smith* 271 Fed. Rep. 211, (C. C. A. 2)), and we may assume that in the absence of any contract they would share alike. Cohan agreed, however, while the work was in preparation that his father was to have all the profits, and this we take at least as a gratuitous contribution of his services. The father thus became the owner of the play, and it passed to his representatives upon his death. Since the widow and the children shared alike, Cohan's part in the royalties was only one third, with which at most his income could be charged. Whether that part passed to his mother depends again upon the effect of the transaction we have been discussing, but which we have hitherto found it unnecessary to decide. Being a right of literary property incapable of delivery, we know of no way by which a valid gift could be made save by deed, (*Beaver* v. *Beaver,* 117 N. Y. 421, 429, 432; *In Re Van Alstyne,* 207 N. Y. 298). While therefore we think that the income should have been reduced by two-thirds of the royalties for 1918, the only year in question,--Cohan must bear his third. The Board's finding is modified pro tanto.

The next question arises over the royalties for the years 1919 and 1920 which came to Cohan for some songs which he wrote for a play called "The Royal Vagabond." All that the findings say, is that he "agreed with his wife, Agnes M. Cohan, to give her the royalties from the sale of the songs." Quite aside from anything else, this does not show even an effort to make a present gift.

Cohan and Harris were joint lessees of a theatre in Chicago, and had assigned the lease to a little company whose shares they held half and half. After the dissolution of the firm in 1920, for a while they tried to apportion their bookings by agreement, but this proved too troublesome, so that in November of that year they agreed that Cohan should have the entire rights in it, Harris to arrange elsewhere for his plays. He needed one hundred and fifty thousand dollars for this purpose, which Cohan lent him, but until August, 1922, they were to use the theatre in common, Harris's profits going to extinguish the loan which he did not personally promise to pay. In October, 1922, they made a second agreement by which Harris in final payment assigned his rights in the lease,--though he had none,--his shares in the company, and his interest in the security which the firm had put up with the lessor.

Cohan deducted the loan from his income in 1920 as an expense, and the Board refused to allow it. His theory is either that it was an expense of his business, or that it purchased certain wasting rights which should be annually amortized. Neither position is good in law. The loan was originally to be repaid out of Harris's earnings from the theatre, apparently on the supposition that these would discharge it within two years. We infer that they did not, else the second agreement would not have been necessary, under which the balance was discharged by the shares and the deposit. Neither the money received, nor the shares, were a wasting asset, unless possibly the shares; but as there is no evidence of any depreciation in the lease between the time of the assignment, October, 1922, and June thirtieth, 1923, the deduction cannot be computed.

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 travelling 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.

There remain two questions relating to the computation of the income, each arising under the statute. Cohan had filed his returns for 1918 and 1919 upon the basis of the calendar year. In December, 1920, he asked leave to change to a fiscal year, from July first to June thirtieth, that being the usual one in theatrical businesses. It was too late under the regulations to get leave for the year 1920, but the Commissioner granted it for the next year, requiring him to file a return for the first six months of 1921, under §212(b) of that Act. This he did not do, but continued to file returns for the calendar years, ignoring the consent. The Board fixed his taxes on the basis of a fiscal year from July first to June thirtieth, beginning in 1921, and of a separate return for the six months between January first and June thirtieth, 1921. Upon the trial he swore a witness who had kept his books, but he did not introduce them, though the Board gave him ample opportunity; because of this failure the testimony was ruled out.

The ruling was plainly right, for, while it is customary to allow accountants and the like to prepare estimates drawn from documents in evidence, this can never be done without the originals themselves, and the argument shows some hardihood. Section 212(b) required the return to be made "in accordance with the method of accounting regularly employed in keeping the books"; and in their absence it could not appear that the books were not kept on the basis of the fiscal year that he had been required to accept. Indeed we must assume that they were, because otherwise the statute would not have justified his demand in December, 1920. Had he chosen to dispute the adminision so implied, his only course was to produce the books, and prove that he had in fact continued to keep them on the "basis" of the calendar year.

The final question arises over the reassessment of the tax for the first six months of 1921. The Revenue Act of 1921 became a law on November twenty-third of that year, eleven months after Cohan had asked for leave to change his accounting period. Title II, (the income tax), of the Act of 1918, was repealed as of January first, 1921, the date on which the same title of the Act of 1921 took effect, (§263). Section 226(c) of 1921 substituted a new method of computing the tax for a part of the year when the taxpayer changed his accounting period under section 226(a). Subdivisions (a) and (b) of that section were the same as the corresponding provisions of the Act of 1918, but under these

it was possible to file a return for a portion of the year as for the whole, thus escaping the heavy surtaxes upon a part of the income for the year in which the change was made. To correct this, subdivision (c) provided in substance that the part should be taken as a proportionate sample of a supposititious income for the whole year, that the tax should be assessed upon the sum so found, but that the taxpayer should pay only that fraction of it which the period of the partial return bore to the whole year.

This was obviously more onerous than what had gone before, and especially so in the case of any receipts which chanced to fall in the fractional period, and which were not recurrent during the remainder. For example, a man who wished to begin his fiscal year in February might make a large profit in January which was not repeated again; yet subdivision (c) required him to compute his tax as though he had got twelve such payments, one in every month, and although he need pay only a twelfth of the total tax so found, he suffered severely in what he did pay. This is an extreme case and Cohan's period was only a half year, yet in that time he got several annual payments which did not recur in the second half of the year. This is his complaint.

The statute is explicit, and if it applies and is valid, he must bear the exaction, for we cannot recast the law by apportioning the unique receipts ratably over a whole year. Had he chosen to change his books after the law was passed, nobody could doubt its applicability, but as we have said, he got permission, and, as the proof stands, committed himself before January 1, 1921, the beginning of the period when by retroaction the Act of 1921 took effect, so that his tax is computed at a much higher rate than any which he could have anticipated. He argues that the statute was not retroactive as to Section 226(c), and that if it was, it was unconstitutional. At the outset we must remember that the question merely concerns the method of computation; the statute reaches nothing that it did not reach before; incomes had been taxed for eight years quite as completely as under the Act of 1921. Furthermore, the change was to correct an omission in the Act of 1918, which allowed taxpayers to escape the high surtaxes imposed as a consequence of the Great War.

Before the decision of *Brushaber v. Union Pacific R. R.,* 240 U. S. 1, 24, 25 [1 USTC ¶4], it had been supposed that the Fifth Amendment did not apply to taxing statutes at all, but the intimations in that case have since been followed by several decisions directly holding the contrary; (*Nichols v. Coolidge,* 274 U. S. 531 [1 USTC ¶239]; *Blodgett v. Holden,* 275 U. S. 142 [1 USTC ¶261]; *Untermeyer v. Anderson,* 276 U. S. 440 [1 USTC ¶297]), and it must now be considered that in extreme cases transactions, untaxed when they took place, cannot be reached by a later statute, certainly when not in contemplation at the time. It is true that *Brushaber v. Union Pacific R. R.* [240 U. S. 1; 1 USTC ¶4], concerned the income tax, but the suggestion there made has as yet borne no fruit in such cases. It appears to us that there is a valid distinction between the taxation of incomes and of gifts or testamentary transfers (*Lewellyn v. Frick,* 268 U. S. 238 [1 USTC ¶133];

Shwab v. Doyle, 258 U. S. 529 [1 USTC ¶61]), certainly as late as 1921. Nobody has a vested right in the rate of taxation, which may be retroactively changed at the will of Congress at least for periods of less than twelve months; Congress has done so from the outset (*Brushaber v. Union Pac. R. R. Co.,* 240 U. S. 1 [1 USTC ¶4]; *Lynch v. Hornby,* 247 U. S. 339 [1 USTC ¶20]). The same rule applies to excises (*Billings v. U. S.,* 232 U. S. 261), even when imposed for the first time. There was here an evil to correct. Before the change, taxpayers had had the opportunity to escape a common burden, which the section ended by adopting a fair rule, taken by and large. True, a portion of a year is often not a fair sample of the whole, but it will work now for, and now against, the individual, as often one was as the other. It is notoriously impossible nicely to adjust the weight of taxes, and it is no objection that upon occasion the result may disappoint reasonable anticipations. The injustice is no greater than if a man chance to make a profitable sale in the months before the general rates are retroactively changed. Such a one may indeed complain that could he have foreseen the increase, he would have kept the transaction unliquidated, but it will not avail him; he must be prepared for such possibilities, the system being already in operation. His is a different case from that of one who, when he takes action, has no reason to suppose that any transactions of the sort will be taxed at all.

No doubt the difference is one of degree, but constitutional matters are generally that; limitations like the Fifth Amendment are not like sailing rules, or traffic ordinances; they do not circumscribe the action of Congress by metes and bounds. Rather they are admonitions of fair dealing, whose disregard the courts will correct, if extreme and glaring. Custom counts for much in such matters, and consistency for little; men cannot hope to fit their doings in advance to a pattern which will be sure to endure. The most they can expect is that courts will intervene when the defeat of their expectations passes any measure that reasonable persons could think tolerable, and even then their grievance must be fairly outside the zone of possible debate.

So it does not seem to us that the situation here calls for so heroic a remedy as to declare the statute unconstitutional, nor indeed for the lesser one of wringing the words out of their natural meaning. Nobody can really think that Section 263 in making Title II of the Act of 1921 date as of January first of that year, excepted subdivision (c) of section 226. In most cases it would operate fairly enough; we could excise only those in which it did not, and that we certainly cannot do. In those cases like *Shwab v. Doyle* and *Lewellyn v. Frick,* the statute was not explicit as here, and while colloquial language is a fumbling means of expression, there are limits to its elasticity; to deny the application of these words to the case at bar seems to us to pass the point of rupture (*Cooper v. U. S.* [280 U. S. 409, 2 USTC ¶486], U. S. Daily, Feb. 27, 1930).

The decision is modified as to the royalties of "Get Rich Quick Wallingford," and the cause is remanded to make some allowance for the expenses of travel and the like; otherwise it is affirmed.

Butler Case

[T.C. Summary Opinion 2006-39]
Carl F. and Frances R. Butler v. Commissioner.

Docket No. 20347-04S . Filed March 16, 2006.

PURSUANT TO INTERNAL REVENUE CODE SECTION 7463(b),THIS OPINION MAY NOT BE TREATED AS PRECEDENT FOR ANY OTHER CASE.

Carl F. and Frances R. Butler, *pro sese*. Bradley C. Plovan, for respondent.

GOLDBERG, Special Trial Judge: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect at the time the petition was filed. The decision to be entered is not reviewable by any other court, and this opinion should not be cited as authority. Unless otherwise indicated, subsequent section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Respondent determined a deficiency in petitioners' Federal income tax of $5,371 for the taxable year 2002.

The issues for decision are: (1) Whether petitioners are entitled to an itemized deduction for medical expenses claimed on their Schedule A; (2) whether petitioners are entitled to claim Schedule C business expenses; and (3) whether petitioners are entitled to Schedule E expenses of $3,368.

Background

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference. Petitioners Carl F. Butler (Mr. Butler) and Frances R. Butler (Mrs. Butler) were married and resided in Keyser, West Virginia, during the taxable year at issue and on the date the petition was filed in this case.

Petitioners' daughter, Carla Rae Butler (Carla), was diagnosed with cancer in 2001 and began chemotherapy treatments at the Johns Hopkins Hospital (Hopkins) in Baltimore, Maryland. During taxable year 2002, Carla continued receiving treatment at Hopkins.

Mrs. Butler and Carla would drive to Baltimore and would stay at Hopkins almost every week from "Tuesday through Friday or Saturday" during Carla's treatment and then return home. During this time, Mr. Butler stayed home in Keyser, West Virginia, and looked after petitioners' two other daughters. Mrs. Butler usually stayed in Carla's hospital room during the treatments at Hopkins. In connection with Carla's treatment, during taxable year 2002, petitioners received two grants of financial assistance from the National Children's Cancer Society of $708 and $472.

Also, during taxable year 2002, Mr. Butler was retired and received Social Security benefits. He suffered from a heart condition, which required him to take several prescription medications. During 2002, he received Medicare reimbursements which paid toward his medications and other medical expenses. Mrs. Butler also had medical issues during 2002.

During the year in issue, Mrs. Butler was employed as a respiratory therapist at Potomac Valley Hospital in Keyser, West Virginia. Mrs. Butler's employer, during 2002, deducted from her earnings health insurance premiums totaling $1,528.30. She was also a self-employed respiratory therapist for Mid-State Medical during the 2002 year. As a self-employed therapist, she made home visits to clients, performing respiratory therapy on them and regulating their medical equipment.

Also, during the year in issue, petitioners owned rental property consisting of a 1972 Challenger trailer (trailer) and land. Mr. Butler purchased the trailer in 1974 and converted it into rental property in either 1993 or 1994. Petitioners rented the trailer to Frank and Nora Miller (Millers) for about 7 months. The Millers paid petitioners $200 per month rent.

Petitioners filed a joint Federal income tax return for 2002, which included a Schedule A, Itemized Deductions, a Schedule C, Profit or Loss From Business, and a Schedule E, Supplemental Income and Loss. Their return was prepared by Fout's Accounting Service in Keyser, West Virginia.

On their jointly filed 2002 tax return, petitioners reported adjusted gross income of $30,878, and claimed Schedule A itemized deductions of $16,094.

On their Schedule A, petitioners claimed the following deductions, in pertinent part:

	Itemized Deductions	Amount
Line 1	Medical and Dental Expenses	$10,723
Line 4	Net medical deduction	8,407
Line 5	State and local income taxes	1,409

Line 6	Real estate taxes	1,303
Line 9	Total taxes	2,712
Line 10	Mortgage Interest	3,083
Line 14	Total interest deduction	3,083
Line 15	Gifts by cash or check	1,642
Line 16	Gifts other than by cash or check	250
Line 18	Total gifts to charity	1,892
Line 26	Net limited misc. deduction	0
Line 28	Total itemized deductions	16,094

Mrs. Butler attached to their 2002 Federal income tax return a Schedule C. On her schedule C for taxable year 2002, Mrs. Butler listed as her principal business or profession: "Respiratory Tech". She reported $10,510 of business income, $10,659 in business expenses, and $771 for expenses for business use of petitioners' home. This resulted in a reported business loss of $920. Mrs. Butler's Schedule C business expenses were as follows:

Line 10	Car and truck expenses	$5,099
Line 16b	Interest (other)	1,042
Line 17	Legal and professional services	125
Line 18	Office expense	656
Line 23	Taxes and licenses	150
Line 24d	Travel, meals, and entertainment	703
Line 25	Utilities	804
Line 27	Other expenses	*2,080*
Line 28	Total expenses	$10,659
Line 30	Expenses for business use of your home	771
Line 31	Net profit or loss	($920)

On their Schedule E for taxable year 2002, petitioners reported income of "rents received" of $1,200 and deducted $3,368 in expenses and depreciation. This resulted in a reported "Supplemental Loss" of $2,168. Petitioners' Schedule E expenses were as follows:

Line 6	Auto and travel	$655
Line 16	Taxes	237
Line 17	Utilities	224
Line 18	Other (yard work and gas mower)	322
Line 20	Depreciation expense or depletion	*1,930*
Line 21	Total expenses	$3,368

On October 14, 2004, respondent issued petitioners a notice of deficiency for taxable year 2002. In the notice of deficiency, respondent disallowed petitioners' claimed deductions for medical and dental expenses along with gifts to charity. The dollar amount of the remaining itemized deductions was less than the 2002 standard deduction for taxpayers married filing jointly; therefore, respondent computed petitioners' 2002 tax deficiency using the standard deduction. Further, respondent, in the notice of deficiency, disallowed petitioners' claimed deductions for Schedule C expenses of $10,659 and Schedule E expenses and depreciation of $1,438 and $1,930, respectively.

At trial, respondent conceded that petitioners have substantiated taxes paid of $1,409, mortgage interest of $3,852, and medical expenses of $4,468. However, due to certain limitations these amounts still do not exceed the standard deduction for taxpayers married filing jointly in 2002.

Discussion

In general, the Commissioner's determination set forth in a notice of deficiency is presumed correct. *Welch v. Helvering,* 290 U.S. 111, 115 (1933). In pertinent part, Rule 142(a)(1) provides the general rule that "The burden of proof shall be upon the petitioner". In certain circumstances, however, if the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the proper tax liability, section 7491 places the burden of proof on the Commissioner. Sec. 7491(a)(1); Rule 142(a)(2). Credible evidence is "'the quality of evidence which, after critical analysis, * * * [a] court would find sufficient * * * to base a decision on the issue if no contrary evidence were submitted'".[1] Baker v. Commissioner, 122 T.C. 143, 168 (2004) (quoting Higbee v. Commissioner, 116 T.C. 438, 442 (2001)). Section 7491(a)(1) applies only if the taxpayer complies with substantiation requirements, maintains all required records, and cooperates with reasonable requests by the Commissioner for witnesses, information, documents, meetings, and interviews. Sec. 7491(a)(2). Although neither party alleges the applicability of section 7491(a), we conclude that the burden of proof has not shifted to respondent with respect to any of the issues in the present case.

Moreover, deductions are a matter of legislative grace and are allowed only as specifically provided by statute. *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering,* 292 U.S. 435, 440 (1934).

Section 6001 and the regulations promulgated thereunder require taxpayers to maintain records sufficient to permit verification of income and expenses. As a general rule, if the trial record provides sufficient evidence that the taxpayer has incurred a deductible expense, but the taxpayer is unable to adequately substantiate the precise amount of the deduction to which he or she is otherwise entitled, the Court may estimate the amount of the deductible expense, bearing heavily against the taxpayer whose inexactitude in substantiating the amount of the expense is of his own making, and allow the deduction to that extent. *Cohan v. Commissioner,* 39 F.2d 540 (2d Cir. 1930). However, in order for the Court to estimate the amount of an expense, the Court must have some basis upon which an estimate may be made. *Vanicek v. Commissioner,* 85 T.C. 731, 742-743 (1985). Without such a basis, any allowance would amount to unguided largesse. *Williams v. United States,* 245 F.2d 559, 560-561 (5th Cir. 1957). With these well-established propositions in mind, we must determine whether petitioners have satisfied their burden of proving that they are entitled to the claimed expenses mentioned above.

1. *Medical and Dental Expenses*

As previously stated, on their Schedule A for taxable year 2002, petitioners claimed a deduction of $10,723 for medical and dental expenses incurred during taxable year 2002. Respondent, at trial, conceded that petitioners substantiated medical and dental expenses incurred during taxable year 2002 of $4,468. However, respondent notes that petitioners did receive reimbursement from the National Children's Cancer Society, Inc. for medical expenses paid relating to Carla of $1,180, which would decrease any deduction allowed for medical and dental expenses paid. Further, respondent contends that petitioners have not substantiated medical and dental expenses incurred during taxable year 2002 above the amount of $4,468.

Section 213(a) allows as a deduction any expenses that are paid during the taxable year for the medical care of the taxpayer, his spouse, and dependents, and that are not compensated for by insurance or otherwise. *Estate of Smith v. Commissioner,* 79 T.C. 313, 318 (1982). The deduction is allowed only to the extent the amount exceeds 7.5 percent of adjusted gross income. Sec. 213(a); sec. 1.213-1(a)(3), Income Tax Regs. The term “medical care” includes amounts paid “for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body”. Sec. 213(d)(1)(A); *Estate of Smith v. Commissioner, supra* at 318-319.

Petitioners claim they are entitled to a deduction of $10,723 for medical expenses incurred as a result of Carla's cancer treatments, Mr. Butler's heart ailments, and other miscellaneous medical expenses relating to Mrs. Butler and petitioners' other children.

At trial, petitioners offered into evidence handwritten lists of medical expenses they claim were incurred during taxable year 2002. However, some expenses on these lists are inconsistent with previous statements made by petitioners. We have taken into consideration all of the documents offered into evidence by petitioners and find that petitioners have substantiated for taxable year 2002: (1) A mileage expense of $926.40[2] for "miles traveled to and from hospitals and doctors"; (2) a medical eye expense of $134; (3) a CT Scan expense of $163; (4)a hotel expense of $100;[3] and (5)other miscellaneous health and hospital expenses of $3,117. The amounts substantiated by petitioners add up to medical and dental expenses paid of $4,440.

Petitioners have not provided sufficient evidence to prove that medical expenses above the conceded amount of $4,468 were incurred during taxable year 2002. Further, the evidence in the record does not allow the Court to estimate any additional amount of medical expenses under the *Cohan* rule. Sec. 6001; sec. 1.6001-1(a), (e), Income Tax Regs.

Due to the fact that the medical and dental expense deduction is allowed only to the extent that the amount exceeds 7.5 percent of petitioners' adjusted gross income and petitioners have not substantiated any additional miscellaneous itemized deductions which would add up to an amount that exceeds the amount of the standard deduction, we sustain respondent's disallowance of petitioners' claimed itemized deductions in favor of the standard deduction.

2. *Schedule C Expenses*

A taxpayer generally may not deduct personal, living, and family expenses. Sec. 262(a). However, section 162(a) allows a taxpayer to deduct all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. To be "necessary" an expense must be "appropriate and helpful" to the taxpayer's business. *Welch v. Helvering,* 290 U.S. at 113-114. To be "ordinary" the transaction that gives rise to the expense must be of a common or frequent occurrence in the type of business involved. *Deputy v. du Pont,* 308 U.S. 488, 495 (1940).

As previously stated, section 6001 and the regulations promulgated thereunder require taxpayers to maintain records sufficient to permit verification of income and expenses. If

the trial record provides sufficient evidence that the taxpayer has incurred a deductible expense, but the taxpayer is unable to adequately substantiate the precise amount of the deduction to which he or she is otherwise entitled, the Court may estimate the amount of the deductible expense, bearing heavily against the taxpayer whose inexactitude in substantiating the amount of the expense is of his own making, and allow the deduction to that extent. *Cohan v. Commissioner, supra.*

In the case of travel expenses, entertainment expenses, and expenses paid or incurred with respect to listed property, e.g., passenger automobiles, section 274 overrides the *Cohan* doctrine, and expenses are deductible only if the taxpayer meets the section's stringent substantiation requirements. Secs. 274(d), 280F(d)(4); *Sanford v. Commissioner,* 50 T.C. 823, 827-828 (1968), affd. 412 F.2d 201 (2d Cir. 1969); sec. 1.274-5T(a), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985).

Section 274(d) specifically provides:

> SEC. 274(d). Substantiation Required. —No deduction or credit shall be allowed —
>
> (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
>
> (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,
>
> (3) for any expense for gifts, or
>
> (4) with respect to any listed property (as defined in section 280F(d)(4)),
>
> unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. * * *

This section "contemplates that no deduction or credit shall be allowed a taxpayer on the basis of such approximations or unsupported testimony of the taxpayer." Sec. 1.274-5T(a), Temporary Income Tax Regs., *supra.*

In order to substantiate a deduction by means of adequate records, a taxpayer must

maintain a diary, log, statement of expenses, trip sheet, or similar record, and documentary evidence which, in combination, are sufficient to establish each element of each expense or use. Sec. 1.274-5T(c)(2)(i), Temporary Income Tax Regs., 50 Fed. Reg. 46017 (Nov. 6, 1985). A contemporaneous log is not required, but corroborative evidence to support a taxpayer's record of the elements of expenditure or use must have “a high degree of probative value to elevate such statement and evidence” to the level of credibility of a contemporaneous record. Sec. 1.274-5T(c)(1), Temporary Income Tax Regs., *supra.* Thus, no deduction for expenses under section 274(d) may be allowed on the basis of any approximation or the unsupported testimony of the taxpayer. See, e.g., *Murata v. Commissioner,* T.C. Memo. 1996-321; *Golden v. Commissioner,* T.C. Memo. 1993-602.

At trial, Mrs. Butler testified that she calculated the Schedule C expenses herself and gave her accountant the worksheets with these calculations to complete petitioners' tax return. However, Mrs. Butler did not offer her detailed worksheets into evidence. She did not keep a trip sheet or log to substantiate her claimed car and truck expenses. Mrs. Butler, however, provided the Court with a list of her purported business expenses. Also, included was a copy of a check made payable to “WV Board of Respiratory Care” of $55. We believe Mrs. Butler's testimony that she incurred other license expenses and continuing education credits of $95 and $260. However, when questioned as to the amounts claimed for the remaining business expenses on her Schedule C, Mrs. Butler's testimony was vague.

Furthermore, with regard to Mrs. Butler's deductions for her business use of her personal residence, section 280A is controlling. Under section 280A, the general rule is that, except as provided by this section, no deduction is allowable unless an allocable portion of the residence is exclusively used as the principal place of any business activity conducted by the taxpayer. All deductions allowable to the business use of the residence must be used to offset the amount of gross income from the business activity and is subject to the 2-percent floor on miscellaneous itemized deductions. Sec. 280A(a), (c)(1), (c)(5).

We have taken into consideration Mrs. Butler's testimony and the handwritten list of claimed Schedule C expenses. We conclude that petitioners are entitled to a business deduction totaling $410. However, we cannot estimate any amounts for petitioners' other business deductions under the *Cohan* rule. Sec. 6001; sec. 1.6001-1(a), (e), Income Tax Regs.

3. *Schedule E Expenses*

Section 212(2) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of property held for the production of income, including real property. Sec. 1.212-1(h), Income Tax Regs.

Further, section 167 generally allows as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business, or property held for the production of income.

However, as previously stated, a taxpayer is required to maintain records sufficient to establish the amount of his income and deductions. Sec. 6001; sec. 1.6001-1(a), (e), Income Tax Regs. In order for a taxpayer to be entitled to a deduction under section 212, he must substantiate his deductions by maintaining sufficient books and records.

Petitioners claim that when the Millers vacated the trailer in 2002, they took the carpeting, furniture, refrigerator, and stove. Petitioners testified that they replaced these items in taxable year 2002.

Unfortunately, the record lacks any receipts or other documentary evidence that would provide any substantiation or a rational basis upon which the Court could allow any deduction and depreciation with respect to the rental property. Further, we note that it appears from the record that the trailer would have been fully depreciated by taxable year 2002. Therefore, we sustain respondent's determination on this issue.

Reviewed and adopted as the report of the Small Tax Case Division.

Decision will be entered under Rule 155.

[1] We interpret the quoted language as requiring the taxpayer's evidence pertaining to any factual issue to be evidence the Court would find sufficient upon which to base a decision on the issue in favor of the taxpayer. See *Bernardo v. Commissioner,* T.C. Memo. 2004-199.

[2] This amount was calculated by multiplying petitioners' substantiated miles traveled of 7,720 by the taxable year 2002 allowable standard medical mileage rate of 12 cents per mile. See Rev. Proc. 2002-61, 2002-2 C.B. 616.

[3] Petitioners substantiated a hotel expense of $250.26 for an evening of lodging away from home. However, this expense is limited to $100 pursuant to sec. 213(d)(2).