Prior Year Depreciation Does Not Establish Basis under Cohan Rule

Cross References

- *Pak,* T.C. Memo. 2024-86

Under the *Cohan* rule, if a taxpayer demonstrates that he or she actually incurred a trade or business expense but is unable to adequately substantiate the amount, the court should estimate the amount and allow a deduction to that extent. To estimate a deduction, the court must have some reasonable evidentiary basis upon which to form the estimate. The court should make as close an approximation as it can, bearing heavily upon the taxpayer "whose inexactitude is of his own making." (*Cohan,* 2nd Circuit Court of Appeals, 1930)

The taxpayer in this case had little to no records. He owned and operated a Japanese steak house restaurant. Both the taxpayer and IRS agreed that it was a "high end" restaurant with hibachi grills, a 25-foot-long sushi bar, and a 16-foot-long martini bar.

The restaurant commenced operations in 2008 in a shopping mall leased space that required substantial, custom "build-out" real property improvements. The improvements were permanent and would be retained by the mall owner in the event the lease ended.

The taxpayer contended that he paid $1,150,000 for the build-out improvements, and $400,000 for the purchase and installation of the hibachi tables. He also claimed he paid $100,000 for other fixtures and equipment, including the sushi bar, martini bar, tables, chairs, and kitchen equipment.

At the time of the tax court trial, the taxpayer did not have records to substantiate these expenditures. However, on his federal income tax return for the 2008 tax year, Form 4562, *Depreciation and Amortization,* was attached which included 7-year property with a basis of $285,000 and nonresidential real property with a basis of $1,380,000, both being placed in service in that year. The 2008 return claimed a $14,605 depreciation deduction.

The taxpayer's 2009 tax year claimed a $113,903 depreciation deduction. A paid preparer prepared the taxpayer's 2008 and 2009 tax returns.

The taxpayer untimely filed his tax returns for tax years 2010 through 2012. He did not use a paid preparer for 2010 or 2011. A depreciation deduction of $2,411 was claimed on his 2010 return and no depreciation deduction was claimed for 2011.

A CPA prepared his 2012 tax return on which no depreciation deduction was claimed.

The taxpayer failed to file returns for tax years 2014 through 2016. The IRS prepared substitute returns for those years in which no depreciation deductions were claimed.

On January 31, 2018, the IRS issued a Notice of Deficiency to the taxpayer for tax years 2010 through 2012 and tax years 2014 through 2016. After receiving the Notices, the taxpayer hired a CPA to evaluate his tax liabilities for those years. In August of 2018, the

CPA prepared and submitted to the IRS amended returns in which additional depreciation deductions were claimed in the amount of $190,106 for 2010, $160,679 for 2011, and $137,171 for 2012. The CPA computed those depreciation amounts by extrapolating from the basis figures that was reported on the taxpayer's 2008 tax return for property placed in service in that year. He did not independently investigate any records supporting the basis figures reported on the 2008 return.

In November of 2018, the CPA prepared Form 1040 returns for the 2014 through 2016 tax years and claimed depreciation deductions of $121,173 for 2014, $106,866 for 2015, and $155,265 for 2016. The CPA computed those amounts in the same manner as with the 2010 through 2012 amended returns.

The IRS did not accept any of the amended returns for tax years 2010 through 2012 or the Form 1040 returns for the 2014 through 2016 tax years.

In court, the taxpayer argued that the IRS accepted his 2008 tax return which contained the correct basis of the property placed in service in that year in which depreciation was claimed, and that the court should invoke the *Cohan* rule to allow the depreciation at issue for tax years 2010 through 2012, and 2014 through 2016.

The court stated it was satisfied that the taxpayer had shown that he incurred expenditures giving rise to the depreciation deduction claimed in 2008, and the IRS did not dispute that the taxpayer incurred expenses in that year to make the build-out improvements. The IRS also conceded that the taxpayer's restaurant was a "high end" restaurant and that it had a 25-foot-long sushi bar and a 16-foot-long martini bar, and that it commenced operations in 2008. Thus, according to the court, the taxpayer had shown that he was entitled to some deduction, as he acquired real and personal property in building out a shell structure and furnishing it in a manner that was sufficient to commence operation of the restaurant in 2008. Such property had a useful life extending to some or all of the tax years at issue in this case.

The court noted that the IRS accepted the taxpayer's 2008 return as filed, and that the statute of limitations had expired for that year. Thus, the IRS is now bound by those basis figures for purposes of the taxpayer's 2008 federal income tax liability. However, those figures do not bind the IRS, or otherwise establish the taxpayer's depreciable basis for purposes of the later years that are at issue in this case. Instead, the court must examine the facts pertaining to the 2008 tax liability as may be necessary to correctly re-determine any deficiency for the tax years 2010 through 2012, and 2014 through 2016 (the years at issue in this case).

The court stated a tax return itself does not establish the truth of the matters. The court is unwilling to attach significance to a taxpayer's prior year returns to establish a basis estimate under the *Cohan* rule "in the absence of corroborating evidence." In this case, there is evidence to corroborate the basis figures claimed on the 2008 return; namely, the undisputed fact that the taxpayer undertook the build-out of a shell structure into a "high end" restaurant that commenced operations in 2008. The 2008 return was prepared by a paid return preparer. While the return preparer was under no obligation to verify the amounts the taxpayer indicated that he had paid to create the nonresidential real property and 7-year property associated with the restaurant, the court stated it believes the figures nonetheless constitute roughly contemporaneous estimates by the taxpayer of the amounts expended.

The figures on the 2008 return appear reasonable. They did not attract the IRS's attention and trigger and audit, nor do they appear unreasonable for a restaurant with its reported gross receipts for that year.

Nevertheless, the court stated the most that can be said for the basis figures on the 2008 return is that they are unsubstantiated estimates. And under the *Cohan* rule, the court "makes as close an approximation as it can, bearing heavily upon the taxpayer whose inexactitude is of his own making."

The court ruled the taxpayer was entitled to depreciation deductions for the years at issue based upon one-half the basis amounts that were reported on the 2008 return.

Author's Comment

This case illustrates the importance of retaining records for closed tax years when those records are needed to substantiate carry forward items to future tax years, such as depreciation, capital loss carry forwards, business credit carry forwards, the nondeductible basis in an IRA, and NOL carry forward deductions. The tax return itself does not establish the basis of items that are carried forward.