STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Department
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March 30, 2004 Information Letter 2003-0303

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Dear************:

I am replying to your inquiry regarding the Estate of ******************** ********. I apologize for any inconvenience caused by the delay of this response.

According to your letter, ******************************, and you were appointed executor of her estate during 1996. Your question is related to the reconstruction of taxable income for the decedent's personal income tax return and the succeeding estate's fiduciary return for the *************. You state that the information needed to calculate the decedent's and the succeeding estate's **** taxable income is unavailable due to the passage of time. Specifically, you ask whether or not the Franchise Tax Board (FTB) would accept a reconstruction of income for the ************* based on the income information available to you from the *************.

As explained below, if the available information indicates that it is reasonable, FTB will accept the **** personal and fiduciary returns filed on behalf of the decedent and succeeding estate with an estimate of their **** income based on the **** income information.

Discussion

The "*Cohan rule*" arose from a case decided by the United States Court of Appeals for the Second Circuit (*Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 540). The *Cohan rule* stands for the proposition that when it is apparent that some business expense or deduction should be allowed, but available records are inadequate to accurately determine the amount of the allowable deduction, the trial court may order a reasonable estimate of the amount based upon the best available evidence. When appropriate, the State Board of Equalization (SBE) has followed the *Cohan rule* in its decisions (e.g., *Appeal of George O. and Alice E. Gullickson*, 82-SBE-117, Jun. 29, 1982). In *Cohan*, the court in part remanded the case to the United States Court of Tax Appeals for an approximation of business expenses while noting:

> Absolute certainty in such matters is usually impossible and is not necessary.
>
> It is not fatal that the result will inevitably be speculative; many important decisions must be such.

Although the *Cohan rule* is typically limited to cases in which a taxpayer is disputing the disallowance of a deduction by a taxing agency, the principle does provide authority for accepting a rational and reasonable estimate of tax-related amounts based on the best available evidence, when a taxpayer is unable to detail a precise amount with the documentation available.

It is well-established that in the absence of a required income tax return, FTB is empowered to estimate appellant's net income from "any available information" and assess the amount of tax due (Rev. & Tax. Code, section 19087; *Appeal of Walter R. Bailey*, 92-SBE-001, Feb. 20, 1992; and *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001). Federal courts have held that a taxing agency has wide latitude in choosing an income reconstruction method (*Palmer v. Internal Revenue Service* (9th Cir. 1997) 116 F.3d 1309, 1312). FTB carries an initial burden of showing that its income estimate is rational and reasonable (*Rapp v. Commissioner* (9th Cir. 1985) 774 F.2d 932; and *Appeal of Michael E. Myers, supra*). In this case, the reverse principle may be implied – that a reasonable and rational estimate of income based on a taxpayer's best evidence available may be accepted by a taxing agency.

This response assumes that the decedent's and the succeeding estate's income, expenses and deductions were periodic in nature and relatively constant from one year to the next and that no better evidence for determining the **** income exists. [1] By signing the decedent's **** personal income tax return and the succeeding estate's **** fiduciary return, the signer would be attesting that to the best of his or her knowledge and belief the returns are true, correct and complete. Accordingly, subject to FTB's usual return review procedures and based on the above discussion, in this case, FTB would view as reasonable and rational an estimate of the decedent's and the succeeding estate's taxable income for the **** tax year based on the applicable income information from the *************.

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[1] Mindful that you have provided no specifics regarding the items of income involved, FTB has one reservation about your proposal to reconstruct **** income using **** income information. The method of reconstructing income you propose could prove inaccurate, if the decedent actively participated in the production of taxable income during the first one-half of the ************* (e.g., salary, wages, or self-employment income).

Please let me know, if you require additional information.

Sincerely,

Andrew O'Boyle
Staff Service Manager
Legal Department