UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH CAROLINA

IN RE:	C/A No. 19-05186-HB
William Cooper Lee and Tracy Quick Lee,	Chapter 12
Debtor(s).	**ORDER OVERRULING OBJECTION TO CLAIM**

THIS MATTER came before the Court for a hearing on April 18, 2024, to consider the Objection to Claim No. 6-4 (the "Objection to Claim") filed by Debtors William Cooper Lee ("Mr. Lee") and Tracy Quick Lee ("Ms. Lee")[1] and the Response thereto filed by the Internal Revenue Service of the U.S. Department of the Treasury (the "IRS").[2] Prior to the hearing, the parties filed a Joint Statement of Dispute (the "JSD"),[3] and Debtors filed a pre-trial brief.[4] Present at the hearing were Robert H. Cooper on behalf of Debtors, Malcolm M. Murray and Austin McCullough on behalf of the IRS, and Chapter 12 Trustee J. Kershaw Spong (the "Trustee").[5] At the hearing, the Court heard testimony and admitted exhibits into evidence. Debtors and the IRS filed post-trial briefs.[6] After carefully considering the evidence, applicable law, and arguments of counsel, the Court finds as follows.

FINDINGS OF FACT

On October 2, 2019, Debtors filed a petition for relief under Chapter 12 of the Bankruptcy Code to initiate the above-captioned case. The Trustee was appointed as Chapter 12 Trustee.

[1] ECF No. 290, filed May 2, 2023.
[2] ECF No. 295, filed June 1, 2023.
[3] ECF No. 357, filed Apr. 17, 2024.
[4] ECF No. 358, filed Apr. 17, 2024.
[5] *See* Transcript of Hearing Held April 18, 2024 (ECF No. 367) (the "Hearing Transcript").
[6] ECF Nos. 370 (IRS' brief) and 371 (Debtors' brief).

Mr. Lee has been a farmer for approximately thirty-seven (37) years and Ms. Lee is a Certified Public Accountant. At the core of this dispute is what Mr. Lee owes the IRS in taxes for the tax years 2006 through 2009 (the "Tax Years").[7] Debtors allege they filed tax returns jointly for the Tax Years, though there are no such returns or copies thereof in this record.[8] The IRS alleges it did not receive any such tax returns, so it prepared a substitute return for Mr. Lee for each year, estimating his income based on information reported to the IRS by third parties and allowing him statutory deductions, but not deductions for expenses incurred in his farming operations, as the IRS did not have records of such expenses. Debtors admit the amount and source of Mr. Lee's gross income for the Tax Years indicated by the IRS' tax transcripts for those years are accurate. However, Debtors argue it was improper for the IRS to not include deductions for Mr. Lee's expenses on the substitute returns. Though Debtors admit they do not have documentary evidence of Mr. Lee's expenses for the Tax Years, they contend that their testimony regarding such expenses is sufficient to estimate those expenses and reduce his tax liability by the amount of the estimate, relying on *Cohan v. Comm'r of Internal Revenue*, 39 F.2d 540 (2d Cir. 1930).

On November 12, 2019, the IRS timely filed Claim No. 6-1.[9]

On January 2, 2020, Debtors filed a Chapter 12 plan.[10] Several objections to that plan were filed.[11] On February 6, 2020, the Court entered an order denying confirmation.[12] On April 1, 2020, Debtors filed a modified Chapter 12 plan that was not confirmed.[13]

[7] Not all the tax liabilities for the Tax Years are associated with Mr. Lee's Taxpayer ID Number on the attachments to the IRS' proof of claim, but Debtors appear to only object to the unsecured portion of the claim related to Mr. Lee's tax liabilities for the Tax Years. However, even to the extent Debtors object to the other tax liabilities for the Tax Years reflected on the attachments to the IRS' proof of claim, the result would be the same.
[8] At the hearing, the parties agreed that Debtors had provided documents purporting to be tax returns for the Tax Years to the IRS. However, those documents are not in evidence.
[9] Debtors filed an objection to this claim (ECF No. 40) but subsequently withdrew it (ECF No. 62).
[10] ECF No. 35.
[11] ECF Nos. 42, 44, 45, 47, and 48.
[12] ECF No. 57.
[13] ECF No. 68.

On May 5, 2020, Debtors filed a *Motion to Value Secured Claim of Internal Revenue Service* requesting that the Court determine the value of the secured portion of the IRS' claim to be $861,788.49.[14] An order was entered on June 8, 2020 granting the motion.[15]

On June 9, 2020—having previously amended its claim on February 6, 2020 (Claim No. 6-2) and on April 6, 2020 (Claim No. 6-3)—the IRS amended its claim again (Claim No. 6-4). Claim No. 6-4 is for $2,955,714.89, with $861,788.49 claimed as secured by all of Debtors' right, title, and interest to property pursuant to 26 U.S.C. § 6321,[16] and $2,093,926.40 claimed as unsecured of which $21,279.46 is claimed as entitled to priority pursuant to 11 U.S.C. § 507(a)(8). The claimed tax liabilities of Mr. Lee for the Tax Years total (including interest) $1,630,292.93, with $503,155.97 claimed as secured and $1,127,136.96 claimed as general unsecured. An attachment to the claim indicates that on October 6, 2011, the IRS recorded a lien with the Clerk of Court for Marlboro County, South Carolina "upon all property and rights to property, whether real or personal" of Mr. Lee securing $1,603,874.39 in unpaid taxes for the tax years 2005 through 2008 pursuant to IRC § 6321 and the related regulations prescribing the procedure for providing notice of such lien.

On June 23, 2020, Debtors filed a modified Chapter 12 plan.[17] In the plan, Debtors proposed to make a number of payments to creditors, pay the IRS' secured claim in full, priority claim in full, and its general unsecured claim on a pro rata basis with other general unsecured claims, with general unsecured creditors receiving at least one percent (1%) on their claims. The plan further provided that, "in the event of any future default in payments due under the plan,

[14] ECF No. 84.
[15] ECF No. 100.
[16] The Internal Revenue Code, Title 26 of the U.S. Code, will hereinafter be referred to as the "IRC". The secured claim amount is consistent with Debtors' motion and the prior order.
[17] ECF No. 107.

which is not cured within 60 days, the trustee is authorized to liquidate additional property, subject to further notice and approval by the Court." On June 25, 2020, the Court approved a Consent Order Confirming Chapter 12 Plan which modified the payments due to the Trustee but otherwise confirmed the plan as filed.[18]

Debtors did not make payments due under the plan, so, pursuant to the terms of the confirmed plan, the Trustee sold property of the estate to make distributions to creditors.

On August 8, 2022, Debtors filed a modified Chapter 12 plan, which provided the same treatment for the IRS' claims as the prior confirmed plan.[19] That plan was confirmed on August 10, 2022.[20]

On February 1, 2023, the Trustee filed a Motion to Dismiss this case based on Debtors' failure to make plan payments.[21] On February 20, 2023, Debtors filed a timely objection to the Trustee's Motion to Dismiss.[22] The hearing on the Trustee's Motion to Dismiss was continued several times on the requests of the parties.

On May 2, 2023, Debtors filed an Objection to Claim No. 6-4.[23] Debtors do not contend that the IRS' claim does not comply with the Federal Rules of Bankruptcy Procedure. Rather, they assert that the unsecured portion of its claim related to Mr. Lee's tax liabilities for the Tax Years should be disallowed to the extent it is excessive due to the IRS not reducing his taxable income by his expenses. On June 1, 2023, the IRS filed a timely Response to Debtors' Objection to Claim.[24] The hearing on the Objection to Claim was continued several times on the requests of the parties.

[18] ECF No. 109.
[19] ECF No. 245.
[20] ECF No. 248.
[21] ECF No. 270.
[22] ECF No. 278.
[23] ECF No. 290.
[24] ECF No. 295.

On April 17, 2024, the parties filed the JSD in which they stipulated to certain facts, set forth their respective positions in more detail, and framed the issues to be decided by the Court.[25] The IRS' position:

> The debtor failed to file tax returns for tax years 2006-2009. The IRS's amended proof of claim of June 9, 2020 is correct because the IRS followed proper procedures for determining the tax liability of a non-filer. In particular, the IRS took into account farming business income for 2006 through 2009 reported to it by third-party payors. Because Mr. Lee neither filed a return nor participated in the audits of those years to determine his liability, he was not allowed any deductions. And around the time this bankruptcy began, the Lees destroyed the documentation that would permit the accurate calculation of their deductions. As a result, Mr. Lee should not be permitted to claim deductions for 2006 through 2009. For 2009, the Lees sold two pieces of real property. The IRS calculated Mr. Lee's tax liability based on the gross proceeds from the two sales.

The Debtors' position:

> The IRS proof of claim is deficient, because although it was based on the amount of gross income the debtors made, and based on documents such as 1098s, 1099s, etc received by the IRS, it did not allow any deductions or expenditures for the debtors, which escalated the amount of tax allegedly owed substantially. Deductions, write offs, exemptions, expenditures, etc are the most promising manner in which any taxpayer, whether consumer or business, survives, as to disallow those things is to put the taxpayer out of business. Any taxpayer disallowed deductions owes taxes, based on straight gross income instead of on receiving taxes owed, based on gross income with no benefit of deductions, the business is doomed. One must ask how this frugal couple could possibly owe almost 3 million dollars in taxes when as seen by tax returns filed both prior to and after the years in question, they basically break even.

The Court held a hearing on this matter and the Trustee's Motion to Dismiss on April 18, 2024. At the hearing, the Trustee stated Debtors are delinquent on payments due under the confirmed plan and therefore need to either catch up on payments or modify the plan. The Trustee indicated the IRS claim needs to be resolved before Debtors can modify the plan and requested the hearing on his Motion to Dismiss be continued until after the Objection to Claim is ruled upon, and without objection, the Court continued that hearing until June 13, 2024.

[25] ECF No. 357.

Mr. Lee, Ms. Lee, and Deborah Estes, an Internal Revenue Agent with the Small Business/Self-Employed Division of the IRS, testified in connection with the Objection to Claim. Debtors testified that there are no longer any expense records for the Tax Years. Mr. Lee testified that his method for keeping records of expenses consisted of putting bills and receipts from vendors in a file in a cabinet in his home and that, at a certain point, he would put the contents of the file into a storage box in an office building he and Ms. Lee own. Mr. Lee testified that heavy rainfall from a storm that occurred around 2010 damaged the office building and the boxes containing his records of expenses for the Tax Years, rendering the records illegible. As a result, the records were thrown away. He said his actual tax returns for the Tax Years were spared from the damage, however, since they were in another part of the office.

Ms. Lee clarified that the office they owned suffered roof damage and flooding, and that the records of expenses for the Tax Years were in an area upstairs where most of the damage occurred. When the Court questioned Ms. Lee about the details of the roof damage, asking if an insurance claim was filed for damage to the office, she could not remember making an insurance claim.[26] She stated that, even if the damage had not occurred, she would have discarded the records by now. Ms. Lee testified that there are no other copies of the expense records for the Tax Years.

Since there are no expense records for the Tax Years, Mr. Lee presented testimony to try to estimate those expenses. Mr. Lee testified that during the Tax Years, he farmed cotton, peanuts, soybeans, and corn. He stated that he has had the same kinds of expenses in all the years he has farmed, consisting of lease payments for land, fuel, seed, fertilizer, chemicals, insecticides, herbicides, labor, harvesting, costs to transport the crops to market, repairs and maintenance on equipment, loan payments, and insurance. Mr. Lee also testified there are expenses particular to

[26] *See* Hearing Transcript, p. 51, lines 23-25, and p. 52, lines 1-21.

certain crops, such as having peanuts dried or cotton ginned. In attempting to estimate expenses for the Tax Years, Mr. Lee stated that he planted "thousands of acres," though he was not sure the exact number, leased "a couple thousand" acres, used about 22,500 gallons of diesel fuel, and used five (5) to six (6) laborers. He estimated the various inputs would have cost the following estimated amounts during the Tax Years: $80.00 per acre for seed; $60.00 – $100.00 per acre for fertilizer, depending on the crop; $400.00 – $500.00 per laborer per week, though wages would depend on the number of acres the laborers were assisting with; $30.00 – $60.00 per acre for chemicals, depending on the crop; $40.00 per acre for harvesting; $50.00 per leased acre; and the cost of transporting the crops to market would have depended on expenses related to the trucks that transported the crops. Ms. Lee concurred in Mr. Lee's testimony regarding expenses. The testimony was quite vague, uncorroborated, and did not provide an estimate of the total amount of expenses for any category or year at issue or any reasonable basis for the Court to make any remotely accurate calculation or estimate.

Mr. Lee generalized that a reasonable expectation for annual "profit" would be about ten percent (10%) or less, and that weather and market conditions might preclude any annual profit. He testified that he has made a profit about once every three (3) years while farming. Mr. Lee stated that his income has always—including during the Tax Years—either been less than his expenses or has exceeded expenses by no more than about ten percent (10%).

Debtors testified they file tax returns jointly. Ms. Lee testified that she, as a CPA, usually prepared joint tax returns for herself and Mr. Lee. Debtors testified they filed tax returns for the Tax Years, but provided little detail of preparation and filing. Mr. Lee stated they have rarely owed much income tax and have never owed any amount approaching what the IRS claims they owe for the Tax Years. Mr. Lee stated those returns showed three (3) years of losses and one (1)

year of profit. As noted above, no such returns or even drafts of such returns are in the record. Mr. Lee testified that he did not recall seeing any letters from the IRS regarding his liabilities for the Tax Years, and that he would have done something if he had known there was an issue. Ms. Lee also testified that she did not recall receiving correspondence from the IRS regarding this matter.

Estes' testimony followed. She has been employed with the IRS since June of 2009, and her role is to examine small business taxpayers, compute tax liabilities, and assess tax. Estes testified she has reviewed various documents in the IRS' file for the Debtors and is familiar with relevant tax liabilities for the Tax Years. She stated that the Account Transcript for 2006 for Mr. Lee (the "2006 Transcript")[27] indicates that Mr. Lee did not file a tax return for that year as required. She testified that the "TXMODA"[28]—a transcript internal to the IRS—reflects that a written notice informing Mr. Lee that he was required to file a return and that the IRS had not received a return was sent to him on April 14, 2008. Estes testified the 2006 Transcript indicates Mr. Lee did not respond to that notice.

According to Estes, if a taxpayer does not respond to such a notice, the IRS uses information from third parties to prepare a substitute return, estimating the taxpayer's income, allowing the taxpayer his statutory deductions and filing status but—in accordance with IRS policy—not making elections such as treating certain transactions as a deductible expense on his behalf, and then computing the tax owed. She testified the 2006 Transcript indicates a substitute return was prepared by the IRS through which the IRS assessed and attempted to collect taxes owed from Mr. Lee for 2006. Estes testified that the substitute return for Mr. Lee for 2006[29]

[27] IRS Ex. A.
[28] IRS Ex. B.
[29] IRS Ex. C.

reflects his income was estimated from information received from third parties and he was allowed a deduction of one half (½) his self-employment tax, his personal exemption, and his standard deduction. However, there was no deduction for Mr. Lee's farming expenses as Debtors did not provide this information to the IRS in a filed return or otherwise. Estes further testified that the TXMODA for Mr. Lee indicates he did not respond to the substitute return, so the collection process began.

Estes testified that, once the collection process begins, notices are sent to the taxpayer informing him of his rights in the collection process and how to make financial disclosures. She said that the TXMODA reflects that at least six (6) notices were sent to Mr. Lee for the 2006 tax year, beginning with the April 14, 2008, notice that he was required to file a return and that the IRS had not received one and continuing until close to the end of 2019. Included in those notices was a letter entitled a "Notice of Deficiency" dated September 20, 2010, and addressed to William Cooper Lee, PO Box 357, Bennettsville, SC 29512 (the "Lee PO Box").[30] Estes testified that Notices of Deficiency are required to be sent by certified mail to the taxpayer's last known address of IRS record. In that Notice of Deficiency, Mr. Lee was advised of the amount he owed according to the substitute return, the procedure to file a petition with the U.S. Tax Court contesting that amount, that the IRS would assess and bill him the deficiency if he failed to file a petition, that he had the right to contact the Taxpayer Advocate, and the contact information for the Taxpayer Advocate and the IRS. Estes testified that neither the 2006 Transcript nor the TXMODA reflect any actions taken by Mr. Lee after the collection process began.

Estes' testimony regarding the 2007 through 2009 tax years was substantively identical to her testimony regarding the 2006 tax year, including that the Notice of Deficiency described above

[30] IRS Ex. C.

was sent to the Lee PO Box for each of those years. There is no evidence that the Lee PO Box did not belong to Debtors or that it was not their last known address of IRS record. Debtors also conceded in the JSD that the IRS issued a Notice of Deficiency to Mr. Lee for all the Tax Years.

Estes testified that the examination file for the 2009 tax year for Mr. Lee[31] reflects that his taxable income for that year included a capital gain of $862,000.00. Counsel for the IRS explained that that capital gain was based on three (3) sales of real property that occurred in 2009. The deeds evidencing those sales[32] reflect that Mr. Lee sold one (1) parcel of real property and Debtors together sold two (2) parcels, with the sales prices totaling $863,500.00. There is nothing in the deeds nor anything else in the record indicating his or their bases in the properties or how long he or they held those properties, and Debtors gave no credible testimony regarding the same.

CONCLUSIONS OF LAW

The parties state in the JSD that there are two (2) primary issues the Court must resolve in ruling on the Objection to Claim: (1) whether Debtors timely filed their federal income tax returns for the Tax Years; and (2) whether Mr. Lee is entitled to take deductions for expenses incurred in his farming operations for the Tax Years, and if so, in what amounts he should be so entitled.

Neither party has asserted that this Court lacks jurisdiction to resolve this dispute. Proceedings regarding "allowance or disallowance of claims against the estate" are core proceedings. 28 U.S.C. § 157(b)(2)(B). "A bankruptcy court generally has the authority to determine a debtor's tax liability and such a proceeding is a core proceeding." *In re N.C. Tobacco Int'l, LLC*, No. 17-51077, 2020 WL 4582282, at *1 (Bankr. M.D.N.C. Aug. 10, 2020) (quoting *In re Starnes*, 159 B.R. 748, 749 (Bankr. W.D.N.C. 1993)). Bankruptcy courts "may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether

[31] IRS Ex. I.
[32] IRS Ex. J, K, and L.

or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction." 11 U.S.C. § 505(a)(1). "The Bankruptcy Code requires bankruptcy courts to defer to the tax court only where the claim was contested *and* adjudicated by the tax court *before* the commencement of the bankruptcy case." *U.S. v. Wilson*, 974 F.2d 514, 517 (4th Cir. 1992) (emphasis in original) (citing 11 U.S.C. § 505(a)(2)). That situation is not present here, and the parties have requested that this Court resolve the dispute.

"[T]he Bankruptcy Code imposes a 'burden shifting framework for proving the amount and validity of a claim.'" *Summit Cmty. Bank v. David*, 629 B.R. 804, 809 (E.D. Va. 2021) (quoting *In re Harford Sands Inc.*, 372 F.3d 637, 640 (4th Cir. 2004)). A proof of claim executed and filed in accordance with the Federal Rules of Bankruptcy Procedure "shall constitute *prima facie* evidence of the validity and amount of the claim." Fed. R. Bankr. P. 3001(f). "'The burden then shifts to the debtor to object to the claim,' and to 'introduce evidence to rebut the claim's presumptive validity.'" *Meral, Inc. v. Xinergy, Ltd.*, No. 7:16CV00059, 2016 WL 7235846, at *3 (W.D. Va. Dec. 13, 2016) (quoting *Harford Sands*, 372 F.3d at 640). "Such evidence 'must be sufficient to demonstrate the existence of a *true dispute* and must have probative force equal to the contents of the claim.'" *Id.* (emphasis in original) (quoting *In re Falwell*, 434 B.R. 779, 784 (Bankr. W.D. Va. 2009)). "[S]hould the debtor carry his burden. . .the burden then shifts back to the creditor, who must prove by a preponderance of the evidence the amount and validity of the claim." *David*, 629 B.R. at 810 (citing *Harford Sands*, 372 F.3d at 640).

The Supreme Court has held that "in the absence of modification expressed in the Bankruptcy Code[,] the burden of proof on a tax claim in bankruptcy remains where the substantive tax law puts it." *Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 26 (2000). In other words, if the

law that gave rise to the tax claim places the burden of proof on the taxpayer to show that the claim is not valid, bankruptcy does not alter that burden of proof. The Fourth Circuit Court of Appeals has summarized the burden of proof that applies to tax claims:

> The burden of proof is on the Commissioner to show that the taxpayer received income. This burden is initially satisfied, however, by the fact that the Commissioner's deficiency determination is presumed correct. The burden is thus on the taxpayer to prove the incorrectness of the deficiency determination. This burden is procedural and is met if the taxpayer produces competent and relevant evidence from which it could be found that he did not receive the income alleged in the deficiency notice. If this burden is met, the burden of proof shifts back to the Commissioner to prove the existence and amount of the deficiency.

Cebollero v. Comm'r of Internal Revenue, 967 F.2d 986, 989 (4th Cir. 1992) (quoting *Foster v. Comm'r of Internal Revenue*, 391 F.2d 727, 735 (4th Cir. 1968)). *See also* IRC § 7491(a) (providing for burden shifting to the IRS in certain circumstances). The taxpayer's burden cannot be satisfied merely by his own self-serving statements. *U.S. v. Brooks*, No. 6:17-cv-2010-TMC, 2019 WL 642917, at *3 (D.S.C. Feb. 15, 2019) (citing *Liddy v. Comm'r of Internal Revenue*, 808 F.2d 312, 315-16 (4th Cir. 1986)).

The Court concludes that the result is the same regardless of whether the burden of proof for objections to claim or the burden of proof for tax claims outside bankruptcy is applied. In either case, the IRS' claim is presumed correct, the burden is on the Debtors to show it is incorrect, and if Debtors meet that burden, the burden shifts back to the IRS to show its claim is correct.

Regarding the first issue the Court must determine—there is no credible evidence in the record of Debtors' filing federal income tax returns for the Tax Years. Debtors did not produce copies of such returns or drafts thereof at trial, the IRS does not have such returns in its records, and all actions of the IRS detailed above are consistent with Debtors' failure to file returns for the Tax Years. Debtors' self-serving testimony regarding the filing of these returns was vague and unconvincing, and the Court is dubious of their testimony that none of the IRS notices reached

them as early as 2008 and that they were never impacted by or aware of the 2011 tax lien. The Court therefore finds, after a careful review of the record and the opportunity to examine the credibility of the witnesses, that no returns were filed for the Tax Years.

Before addressing the second issue—whether Mr. Lee is entitled to deductions for expenses and if so, in what amount—the Court must address two (2) threshold issues. The first is Debtors' contention raised in their post-trial brief that the IRS is time-barred from collecting taxes owed for the Tax Years. If a taxpayer fails to file a required return, the IRS is required to prepare a substitute return based on information it has or can obtain. *See* IRC § 6020(b)(1). "In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, **at any time.**" IRC § 6501(c)(3) (emphasis added). This means that, when a taxpayer fails to file a return, IRC § 6501(c)(3) allows the IRS to assess taxes or initiate a civil tax proceeding against a taxpayer at any time. *See Kaplan v. Comm'r of Internal Revenue*, 795 F.3d 808, 812 (8th Cir. 2015) (citing IRC § 6501(c)(3)). *See also Kaplan v. Comm'r of Internal Revenue*, No. 25652–12, 2014 WL 988465, at *8 (T.C. Mar. 13, 2014) (citing 26 C.F.R. § 301.6501(b)–1(c)) ("A substitute for return prepared under section 6020(b) is not considered a return for the purposes of starting the assessment period."), *aff'd*, 795 F.3d 808 (8th Cir. 2015). Accordingly, Debtors' argument is without merit.

The second is whether the IRS fulfilled its obligations under the IRC with respect to the Notices of Deficiency. If the IRS determines there is a deficiency in—among other taxes—income or estate and gift taxes, the IRS "is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail." IRC § 6212(a). A notice of deficiency in—among other taxes—income and gift taxes "if mailed to the taxpayer at his last known address, shall be sufficient for purposes of" the provisions of the IRC relating to such taxes. IRC § 6212(b)(1). The record

indicates these procedures were complied with, so the Court rejects any assertion by Debtors that the Notices of Deficiency were not properly sent. Also, as stated above, testimony that none of the IRS notices reached them and that they were never impacted by or aware of the tax lien lacks credibility.

Finally, the Court will address whether Debtors have met their burden to show that Mr. Lee is entitled to deduct expenses from his taxable income for the Tax Years, resulting in disallowance of a portion of the IRS' claim. When a tax return is properly filed, the IRC allows deductions for certain ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. *See* IRC § 162. The IRC also allows individuals deductions for ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax. IRC § 212. The taxpayer must provide certain evidence substantiating expenses for traveling claimed under IRC §§ 162 and 212, any expense for gifts, or with respect to any listed property (as defined in IRC § 280F(d)(4)) in order to claim deductions or credits for those expenses. *See* IRC § 274(d).

IRS regulations clarify that such substantiation consists generally in "adequate records or. . .sufficient evidence corroborating [the taxpayer's] own statement." 26 C.F.R. § 1.274–5T(c)(1). However, "[w]here the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as destruction by fire, flood, earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures or use." 26 C.F.R. § 1.274–5T(c)(5). "In order to take advantage of this exception, a taxpayer must prove that he had records which

would have adequately substantiated his or her expenses and that those records were destroyed or lost in a casualty beyond the taxpayer's control." *Campbell v. Comm'r of Internal Revenue*, 164 F.3d 1140, 1143 (8th Cir. 1999) (internal quotation marks and citation omitted).

It is a "'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" *INDOPCO, Inc. v. Comm'r of Internal Revenue*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines v. Comm'r of Internal Revenue*, 319 U.S. 590, 593 (1943)). "[T]he burden is upon the taxpayer to establish the amount of a deduction claimed." *Helvering v. Taylor*, 293 U.S. 507, 514 (1935) (citations omitted). *See also In re Landbank Equity Corp.*, 973 F.2d 265, 271 (4th Cir. 1992) (emphasis in original) (the IRS is not obligated "to determine and allow deductions to the taxpayer. As a matter of legislative grace, deductions may be claimed and are allowed to the extent *the taxpayer* can prove them, whether the taxpayer is a debtor in bankruptcy or not.").

"It is the taxpayer who bears the burden of establishing the basis for each transaction. . .and when a taxpayer fails to meet this burden, it is proper to assume that the asset has a zero basis[.]" *U.S. v. Brooks*, No. 6:17-cv-02010-TMC-JDA, 2018 WL 7568392, at *6 (D.S.C. Dec. 19, 2018) (citations omitted). *See also WMI Holdings Corp. v. U.S.*, 891 F.3d 1016, 1022 (Fed. Cir. 2018) (quoting *Better Beverages, Inc. v. U.S.*, 619 F.2d 424, 428 n.4 (5th Cir. 1980)) ("Where the taxpayer fails to carry this burden to prove a cost basis in the item in question, the basis utilized by IRS, which enjoys a presumption of correctness, must be accepted even where. . .the IRS has accorded the item a zero basis."). Regarding any adjustment related to long-term capital gains, it is the taxpayer's burden to show entitlement to such favorable treatment. *See Ju v. U.S.*, 170 Fed. Cl. 266, 273 (Fed. Cl. 2024) (quoting *Free-Pacheco v. U.S.*, 117 Fed. Cl. 228, 292 (Fed. Cl. 2014))

(the taxpayer "has the burden of proving that a section of the Internal Revenue Code applies to him, before he is able to benefit from its provisions.").

Taxpayers are required to keep records relevant to the determination of their tax liability. *See* IRC § 6001. Farmers are required to keep records related to their income that will enable the IRS to determine the correct amount of taxable income, and those records "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." 26 C.F.R. § 1.6001–1(b), (e). IRS regulations provide documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure, is required for any expenditure for lodging while traveling away from home and any other expenditure of $75.00 or more except, for transportation charges, documentary evidence will not be required if not readily available. 26 C.F.R. § 1.274–5(c)(2)(iii).

As Debtors no longer have records of their expenses for the Tax Years, they rely on the testimony. They contend that Mr. Lee's tax liability for the Tax Years—and consequently the unsecured portion of the IRS' claim that relates thereto—should be reduced by the amount of their estimate of such expenses, citing the *Cohan* case noted above in support.

The *Cohan* case dealt with several tax issues arising for George M. Cohan, a theatrical producer and playwright. *Cohan*, 39 F.2d at 541. In producing his plays, Cohan spent a great deal of money traveling and entertaining others. *Id.* at 543. Cohan, however, did not keep records of these expenses, and the Second Circuit Court of Appeals concluded he "probably could not have done so." *Id.* At a trial before the U.S. Board of Tax Appeals, he estimated that he had had about $55,000.00 in entertainment and travel expenses. *Id.* The Board did not allow him to claim any

of the $55,000.00 as a deductible expense because there were no details substantiating that estimate. *Id.*

The Second Circuit Court of Appeals concluded that Cohan's expenses, though not known exactly, were certainly "substantial." *Id.* The Court found that while the Board was entitled to "[bear] heavily. . .upon the taxpayer whose inexactitude is of his own making", it "should make as close an approximation [of expenses] as it can", drawing, if necessary, "upon the Board's personal estimates of the minimum of such expenses." *Id.* at 544. Accordingly, the Court required the Board to reconsider the evidence. *Id.*

In the years since the 1930 *Cohan* decision, record keeping has evolved and the IRC has been revised. "The substantiation requirements of [IRC § 274(d)] were intended to abolish the *Cohan* rule and require the taxpayer to prove the exact amount and circumstances of the deduction; otherwise it would be disallowed entirely." *Berkley Mach. Works & Foundry Co. v. Comm'r of Internal Revenue*, 623 F.2d 898, 902 (4th Cir. 1980) (citing H. R. Rep. No. 1477, 87th Cong., 2d Sess. 19 (1962-3 Cum. Bull. 405, 427)). *See also Charron v. U.S.*, 200 F.3d 785, 794 (Fed. Cir. 1999) ("the *Cohan* rule has been superseded by section 274(d) of the Internal Revenue Code, which now governs the deductibility of entertainment and travel expenses.").

However, to the extent courts have continued to apply *Cohan* to these deductions, they have imposed strict requirements. For the *Cohan* rule to apply, there must be evidence showing that the taxpayer is entitled to the deduction and "sufficient evidence in the record from which the Court may estimate the exact amount." *Trigon Ins. Co. v. U.S.*, 234 F. Supp. 2d 581, 588 (E.D. Va. 2002). "[C]ourts have declined to apply *Cohan* in cases where there is no doubt that the taxpayer incurred some deductible expense, but the taxpayer failed to present evidence sufficient to allow the court to make an accurate finding on the amount of the deduction." *Id.* at 589-90

(citing cases). *See also Williams v. Comm'r of Internal Revenue*, No. 11290–92, 1994 WL 50462, at *2 (T.C. Feb. 22, 1994) ("in order for this Court to apply the rationale of *Cohan.* . .to any particular disallowed expenditure, there must be sufficient evidence to permit us to make an estimation. . . . Self-serving, vague, and undocumented testimony is insufficient."). The Fourth Circuit Court of Appeals has found *Cohan* inapplicable "where the claimed but unsubstantiated deductions are of a sort for which the taxpayer could have and should have maintained the necessary records." *Pridgen v. Internal Revenue*, 2 F. App'x 264, 274-75 (4th Cir. 2001) (quoting *Lerch v. Comm'r of Internal Revenue Serv.*, 877 F.2d 624, 628 (7th Cir. 1989)). This contrasts with the *Cohan* court's finding that Cohan "probably could not have" maintained the necessary records. *Cohan*, 39 F.2d at 543.

Assuming, for the sake of argument, that the *Cohan* rule applies to this matter, the Court concludes that the evidence presented by Debtors here is simply insufficient. Debtors have failed to meet their burden to present evidence sufficient and reliable enough to allow the Court to make even an approximate guess on the amount of any deduction and thus have failed to show that the IRS' claim should be reduced. Even assuming Debtors did have records substantiating the relevant expenses, and that such records were destroyed in a flood beyond Debtors' control, their testimony is not a "reasonable reconstruction" of those expenses.

The only evidence in the record is testimony provided fifteen (15) to eighteen (18) years after the period in question, which was vague, self-serving, and uncorroborated by any documentation of expenses actually incurred or of expenses that would have been typical for the industry in the locale at the time. Debtors did not even provide a total dollar estimate of expenses, and although they asserted that they incurred similar types and amounts of expenses in the years prior and subsequent to the Tax Years, and that the returns for such years showed minimal

liabilities or even refunds, they did not provide any such returns to the Court and any such returns would be of limited relevance in any event. This is not a sufficient basis on which the Court may make an estimate.

There are also no grounds on this record for the Court to reduce the tax liability in connection with the sales of real property in 2009. The burden is on Debtors to establish the bases in the properties and length of ownership, but there is nothing in the record regarding those issues.

The Court is compelled to agree with counsel for the IRS that this case "is an example of too little, too late."[33] Exceedingly too little, and monumentally tardy. Even to the extent *Cohan* is viable in this matter, Debtors have presented no principled basis for the Court to estimate expenses for the Tax Years.

IT IS, THEREFORE, ORDERED the Objection to Claim No. 6-4 filed by Debtors William Cooper Lee and Tracy Quick Lee on May 2, 2023, is overruled.

FILED BY THE COURT
06/05/2024

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH CAROLINA

Chief US Bankruptcy Judge
District of South Carolina

Entered: 06/05/2024

[33] Hearing Transcript, p. 12, lines 20-21.