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Effect of the 1962 Revenue Act on Travel, Entertainment, and Gift Deductions

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NOTES

EFFECT OF THE 1962 REVENUE ACT ON TRAVEL, ENTERTAINMENT AND GIFT DEDUCTIONS.

I. INTRODUCTION.

On November 8, 1962, IRS Commissioner Mortimer Caplin published the first group of proposed regulations[1] to implement the travel, entertainment and gift provisions of the 1962 Revenue Act,[2] and initiated a controversy between Treasury officials and commercial interests that lasted through the winter months.[3] On February 28, the Commissioner was summoned before the Senate Finance Committee to defend Revenue handling of the provisions against the mounting criticism.[4] This preliminary indication of Congressional concern was substantiated when Senator Smathers introduced a bill to repeal certain of the 1962 travel and entertainment restrictions.[5]

Critics of the new "T & E" provisions may be divided generally into two groups; those who protested against allegedly unreasonable substantiation requirements, and those who protested against the new restrictions on certain formerly allowable types of expense, regardless of substantiation.

At the December 4 hearings, Commissioner Caplin met the first group with an announcement that the substantiation proposals were being studied with a view toward relaxing some of the more rigorous requirements.[6] On December 28, the final regulations were published, and, as promised, much of the detail had been eliminated.[7] The new rules are strict, but realistic, and accord with principles of internal cost control that a modern business concern might adopt for its own purposes.

The second group of critics has also found some governmental deference to their views. Although the thrust of the statute was to curb "expense account living," the regulations[8] explaining the nature of a deductible travel, entertainment and gift expense have been drafted in such a way as to cause even the National Restaurant Association to concede that the IRS has arrived at "a fairly liberal interpretation of last year's law."[9]

This note will discuss how the substantiation provisions will be applied to allowable expenses of both the individual taxpayer and within the existing corporate framework.

II. HISTORICAL BACKGROUND.

The travel, entertainment and gift reforms imposed by the 1962 Act are the culmination of a long campaign by the Treasury Department to put an end to "expense account living."[10]

Several factors made allowance of these personal living expenses possible. First, due to the broad judicial construction given the general business expense requirements, that they be "ordinary and necessary,"[11] distinctions between personal and business expenses broke down. The ensuing doubt caused many taxpayers, uncertain of deductibility, to take the deductions, placing the burden of determining

1 Proposed Treas. Reg. § 1.274-5, 27 Fed. Reg. 10894-900 (1962).

2 76 Stat. 960 (1962).

3 Much of the furor was raised by the National Restaurant Association, which claimed that IRS distortion of the "T & E" provisions had caused restaurant business to decline 30% in January in some areas.

4 Wall Street Journal, Feb. 28, 1963, p. 1, col. 6.

5 S. 1083, 88th Cong., 1st Sess. (1963).

6 Wall Street Journal, Dec. 5, 1962, p. 3, col. 1.

7 Treas. Reg. § 1.274-5 (1962).

8 Treas. Regs. §§ 1.274-1, 2, 3, 4 (1963).

9 South Bend Tribune, March 30, 1963, p. 1, col. 1.

10 See *Expense Account Aristocracy*, Life, March 9, 1953, p. 140; Lynes, *Visit to the World of Expense Accounts*, N. Y. Times, Feb. 24, 1957, (Magazine Section) p. 17.

11 Section 162 of the Internal Revenue Code provided:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred . . . in carrying on the trade or business. . . . INT. REV. CODE OF 1954, § 162(a).

their validity on the IRS.[12] Less conscientious taxpayers capitalized on the confusion to fraudulently deduct expenses they knew to be personal.[13]

A second factor adding to the confusion was the advent and widespread reliance on the *Cohan* rule.[14] Although the regulations have required substantiation previously,[15] the Internal Revenue Service could not insist on such support. The *Cohan* rule allowed a taxpayer who failed to keep records to estimate his expenses after reconstructing the transactions in which they were incurred. According to Commissioner Caplin, *Cohan* stimulated a practice termed "Cohan gamemanship," by which taxpayers deliberately overestimated expenses for purposes of negotiation with the IRS.[16] The seriousness of this problem was heightened by the fact that many returns were never audited and the claimed deductions passed unquestioned.

The Treasury Department first noted its concern over expense-account abuses in 1952.[17] Since then, investigations have been made periodically, resulting in Revenue Rulings[18] and Treasury Releases[19] aimed at correcting the abuses within the framework of existing law. The programs of stricter enforcement were ineffective, however, because of the *Cohan* rule.

Recognizing the futility of trying to eliminate expense-account abuses without new legislation, the service tried in the 82nd and 86th Congresses to get remedies. The first attempt failed to muster necessary support.[20] The second, a provision to limit gifts, entertainment, and club dues, was shelved in 1960 to permit a Congressionally directed study of abuses to determine the scope of the problem.[21]

Armed with the results of this study, on April 20, 1961, President Kennedy sent a message to Congress asking virtual abolition of entertainment, travel and gift deductions.[22] According to the President, "The slogan — 'It's deductible' — should pass from our scene."[23]

III. Section 274 — The New Provisions.

Section 4 of the 1962 Revenue Act (Section 274 of the 1954 Code) is the compromise result of the Administration's proposals and the views of business leaders.[24] The new provisions drastically reshaped the law, abolishing the *Cohan* rule, imposing definite record-keeping standards in its place,[25] and making important changes in the extent to which travel, entertainment and gift expenses are deductible.[26]

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12 Caplin, *The Travel and Entertainment Expense Problem,* 39 Taxes 947, 955 (1961).
13 *Ibid.*
14 Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).
15 Treas. Reg. § 1.162-17 (1955).
16 Caplin, *supra* note 12 at 961.
17 In a press release, the Bureau of Internal Revenue announced that travel and entertainment deductions would be subject to close scrutiny in the future. Bur. of Int. Rev., Release No. S-2979, February 26, 1952.
18 Rev. Rul. 54-195, 1954-1 Cum. Bull. 83, cited the fraudulent deduction of personal items and outlined guides for revenue agents to use in determining whether a "T & E" item was deductible. Rev. Rul. 60-120, 1960-1 Cum. Bull. 83 explained the type of system required to be maintained by an employer in order to qualify for IRS deference.
19 T.I.R. 198 (1958); T.I.R. 221 (1960).
20 In addition to the strong pressures expected from business and professional groups, advocates of greater deductibility received an unexpected boost from Commissioner T. Coleman Andrews, who expressed the belief that the problem was an administrative one.
21 74 Stat. 291 (1960).
22 H.R. Doc. No. 140, 87th Cong., 1st Sess. (1961).
23 *Ibid.*
24 The President requested virtual abolition of the travel, entertainment and business gift deduction. After listening to business leaders, who favored the status quo, Congress imposed mandatory substantiation requirements and changed the extent to which some of the more obvious abuses would be deductible. S. Rep. No. 1881, 87th Cong. 2d Sess. (1962).
25 Treas. Reg. § 1.274-5.
26 Int. Rev. Code of 1954, §§ 274(a), (b), (c).

A. Procedural Changes — Records Required.

1. Abolition of the Cohan Rule. — The most significant change brought about by Section 274 is the abolition of the *Cohan* rule. In *Cohan v. Commissioner*,[27] George M. Cohan sought to deduct travel and entertainment expenditures which the Commissioner had disallowed for lack of substantiation. The court held that where it is evident that the taxpayer has incurred an expense, the amount of which is uncertain for lack of adequate records, the fact-finder must allow as close an approximation as can be made and cannot disallow the deduction entirely. The court may, however, "bear heavily" on the taxpayer whose carelessness makes the approximation necessary.[28] The *Cohan* rule has been praised by many authorities as providing the taxpayer with a tool for asserting obvious deductions,[29] and countless compromises have doubtless been effected at the administrative level.

Despite these defenses, *Cohan* is gone, and for the first time the IRS may effectively demand proof for claimed deductions. The new byword is "prove the deduction or lose it."

2. Substantiation under the New Provisions. — Although the substantiation regulations are rather detailed, the policy on which they are based is easily expressed; substantiation records will be granted a degree of credence increasing directly with the extent to which they (1) exhibit a well-organized documentation of the item described, and (2) are prepared contemporaneously with the expenditure.

To articulate this policy, the regulations describe several methods of acceptable record-keeping. The ordinary method, called "adequate records,"[30] involves keeping an expense diary and will be given the highest degree of probative effect. A taxpayer who fails to meet this standard may still support an expense by submitting his own statement plus "other sufficient, (corroborative) evidence."[31] In the case of a taxpayer who establishes that the situation in which the expense was incurred precluded him from acquiring evidence "adequate" or "sufficient," substantiation may be effected by presenting evidence of the "highest probative value" under the circumstances.[32] Finally, a taxpayer whose records have been destroyed through no fault of his own will be allowed to reconstruct his expenses.[33]

(a) Adequate Records. — The new regulations accord favored treatment to the taxpayer who contemporaneously records expense items in an "account book, diary, statement of expense or similar record."[34] The "contemporaneous" requisite is met when the item is recorded ". . . at a time when, in relation to the making of an expenditure, the taxpayer has full present knowledge of each item of the expenditure. . . ."[35]

Several factors should make this method of supporting an expense item prevail. The small amount of time involved in making the required entry, contrasted with the time-consuming requirements of secondary methods, provide the businessman with a minimum of time spent on such nonproductive pursuits. The primary probative effect given this method by the regulations, coupled with the impression of business-like efficiency given an agent at audit time are other important factors.

(b) "Other Sufficient Evidence." — Where a taxpayer is remiss in keeping "adequate records," he may still qualify an expense by submitting his own written statement *and* other direct evidence, such as the written or oral testimony of wit-

27 39 F.2d 540 (1930).
28 *Id.* at 544.
29 E.g., 4 Mertens, Federal Income Taxation, § 25.04 (1960 rev.).
30 Treas. Reg. § 1.274-5(c)(2). This section also states that substantial compliance, or a bona fide attempt to meet "adequate records" will qualify.
31 Treas. Reg. § 1.274-5(c)(3).
32 Treas. Reg. § 1.274-5(c)(4).
33 Treas. Reg. § 1.274-5(c)(5).
34 Treas. Reg. § 1.274-5(c)(2).
35. *Ibid.*

nesses, or a receipt, as corroboration.[36] The cumbersome steps involved in gathering supporting evidence at some time after the expense item was incurred, plus the inferior deference accorded this method, make it undesirable. It may have limited applicability in an efficient record system, however, where the taxpayer forgets to record an item at the time incurred and later desires to supplement his expense diary with the item.

(c) Receipts, Paid Bills, Etc. — In two situations, the taxpayer will be required to produce receipts supplementing his own records. The first is any expenditure in excess of $25.[37] In raising this limit from $10, the IRS stilled much of the criticism of the substantiation regulations. The second type of expenditure for which a receipt is needed is lodging while traveling away from home.[38] Several documents, such as a cancelled check and paid bill, may be used to support separate elements of the expenditure.[39]

(d) Elements Required to be Recorded (Proved). — By its nature, an expense diary cannot contain more than a brief summary of each expense item. As explained above, the regulations contemplate (1) a reasonable record system, and (2) entries "at or near" the time of expenditure. Although the elements to be proved vary with the nature of the expense, a summary of the general elements is helpful at this point.

§ 1-274-5(b)(1) announces that no expense deduction for travel, entertainment or business gifts will be allowed unless the following elements are substantiated: amount, time, place, business purpose, and business relationship of the participants. While the first three elements are largely mechanical tools to reduce unfounded overestimates, the latter two go to the very nature of the expense item, and determine whether the participants and purpose bear a close enough relation to business objectives to warrant deduction.

The Internal Revenue Service has indicated that relatively cryptic entries will suffice under the "adequate records" method of compliance if the elements are all present.[40]

(e) Rules of Convenience in Record-Keeping. — In drawing guidelines for combining the correct record systems and their contents, the regulations have provided several accounting rules of convenience. Generally, each payment will be considered a separate expenditure (to be recorded) unless it is one of a series of repetitious expenditures, in which case they are to be grouped as a single expenditure.[41] For example, expenses for entertaining a client at dinner and the theater are considered separate expenditures in making the diary entry and applying the $25 limitation. On the other hand, payment for cocktails after each round is served does not establish a series of expenditures. Rather, the aggregate amount must be treated.

The following classes of items may, at the option of the taxpayer, be treated as a daily total for purposes of making diary entries: meals, gasoline and oil; taxi fares, telephone calls and tips.[42]

In the usual case, where a number of persons are entertained, the taxpayer will deduct the actual expenses attributable to those with whom the required business relationship exists.[43] If only the total amount is known, the pro-rata share of those for whom deduction is allowable is the correct amount to be claimed.[44]

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36 Treas. Reg. § 1.274-5(c)(3).
37 Treas. Reg. § 1.274-5(c)(2)(iii).
38 *Ibid.*
39 *Ibid.*
40 Questions and Answers furnished by the IRS on Substantiation, No. 35, Ex. 1, 2, December 28, 1962.
41 Treas. Reg. § 1.274-5(c)(6).
42 Treas. Reg. § 1.274-5(b)(2).
43 Treas. Reg. § 1.274-5(c)(6).
44 *Ibid.*

In addition, the *Sutter* rule will continue to apply, making the taxpayer's expenses for participating in the entertainment deductible only to the extent they exceed his normal expenses.[45]

B. Substantive Changes — The Nature of the Deductible Expense.

The new provisions have also made substantive changes in the extent to which affected expenses are deductible. New standards have been posed for entertainment-activity expense,[46] entertainment facilities,[47] travel expenses[48] and business gifts.[49] As explained in the foregoing section, certain general elements must be recorded in making any expense-account deduction. The following sections will discuss the specific applications of these elements as they relate to the type of expense considered.

1. Entertainment Activities. — The proposed regulations define entertainment as "any activity which is of a type generally considered to constitute entertainment, amusement or recreation, . . ." and ". . . includes any expenditure incurred in satisfying the personal, living or family needs of any individual . . ." claimed as a business expense.[50] Typical examples are theater or night-club outings.

Under former law, expenses of this type were deductible if they passed the tests set up by § 162(a) for business expenses generally — that is, they had to be "ordinary and necessary" in carrying on the business. The regulations further required that the expense be "directly connected with or pertaining to the taxpayer's trade or business."[51]

Applying these standards, the judiciary required generally an ascertainable business objective and a good chance of accomplishing this objective.[52] Because promotional needs differ among types of business, the cases reached apparently divergent results. Thus, a taxpayer's expense in preparing a rumpus room for entertaining customers was disallowed[53] while an actor was allowed to deduct sums spent entertaining a wide entourage, ranging from princesses to pugilists, as they enhanced his popularity, an important factor in his career.[54] In another case, the court allowed the taxpayer to deduct the costs of an African safari, where movies of the trip were shown to customers and a "name the tiger" contest was run in local newspapers.[55] Generally, however, when the connection between the expense and business objectives became unclear, the expenses were disallowed. Thus, a pipe manufacturer was disallowed maintenance expenses for a lavish garden that he contended put customers into a favorable business mood. The court said:

> The relationship between the aesthetic stimulation of a potential customer from the view of an unusual array of shrubbery and flowers and his order for pipe is much too oblique.[56]

Section 274 signals a further movement, requiring a closer proximity between the expense and an attainable business purpose. The general standards of Section 162, that the expenses be ordinary and necessary, still apply.[57] In addition, § 274 states that no deduction shall be allowed for an entertainment expense unless it

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45 IRS News Release, March 30, 1963; Sutter v. Comm'r, 21 T.C. 170 (1953) (dictum); Comm'r v. Doak, 234 F.2d 704 (4th Cir. 1956).
46 INT. REV. CODE OF 1954, § 274(a).
47 *Ibid.*
48 INT. REV. CODE OF 1954, § 274(c).
49 INT. REV. CODE OF 1954, § 274(b).
50 Treas. Reg. § 1.274-2(b)(1)(i) (1963).
51 Treas. Reg. § 1.162-1(a) (1958).
52 *E.g.*, Binghams Trust v. Comm'r, 325 U.S. 365 (1945); Blackmer v. Comm'r, 70 F.2d 255 (2d Cir. 1934); Schulz, 16 T.C. 401 (1951).
53 B. V. Nottingham Est., 15 T.C. Mem. 1454 (1956).
54 Blackmer v. Comm'r, 70 F.2d 255 (2d Cir. 1934).
55 Sanitary Farms Dairy, Inc., 25 T.C. 463 (1955).
56 Louis Greenspon, 23 T.C. 138, 151 (1954), *aff'd on this point*, 229 F.2d 947 (8th Cir. 1956).
57 INT. REV. CODE OF 1954, § 274(a); Treas. Reg. § 1.274-1.

is established that the item was "*directly related to* . . . the *active* conduct of the taxpayer's trade or business." (Emphasis supplied)[58]

One writer has expressed the opinion that the new act has merely codified existing standards of proximity laid down by judicial interpretation of § 162 and the regulations.[59] This opinion serves as a valuable indicator in surveying the new standards. It points out that they are still somewhat general, and will produce results which vary with the factual situation to which they are applied. It also indicates that the Senate Finance Committee did not extend the changes as far as the Administration desired. Commenting on Committee modifications of the House bill, Senator Douglas said:

> The vague and almost meaningless standard adopted by the Committee will do very little, if anything, to change the style of operation of those who have been living high on their expense accounts at the cost of their fellow citizens.[60]

The Majority Report indicated that change was intended, however:

> He [taxpayer] must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law.[61]

According to the Report, it was contemplated that the taxpayer show a "reasonable expectation of deriving some income or other benefit to the business as a result of the expenditure."[62]

Accepting this statement as a touchstone, the regulations state a general definition of "directly related entertainment"[63] and several specific types of entertainment to which special rules apply.[64]

The general definition of "directly related" requires, (1) that the taxpayer must expect to derive some income or other specific business benefit other than good will immediately or at a definite or readily determinable future time from the expenditure, (2) that he did engage in active conduct of the business during the entertainment period, (3) to the extent that the principal character of the combined business and entertainment activity was the active conduct of the business.[65] In addition, the expenditure must be allocable to a business associate — one with whom the taxpayer engages in active conduct of the business.[66] Thus, expenses attributable to a customer's wife will not be considered "directly related."

In addition to the general "directly related" test, rules have been provided for specified activities. If the expenditure was made for entertainment occurring in a "clear business setting directly in furtherance of the taxpayer's business," the item is considered to be "directly related."[67] Under this test, the rigors of "directly related" are lessened by the addition of a setting which is conducive to business activity. A "clear business setting" contemplates that the recipient of the entertainment be able to draw but one conclusion — that no motive other than directly furthering the business is intended. For example, expenses incurred in providing a "hospitality room" at a convention at which good will is created through displays and discussion of the taxpayer's product, are deductible.[68]

A second type of expense for which a specific test is provided is that incurred by the taxpayer for the benefit of one other than an employee and required to be included in the recipient's gross income under § 74.[69] Typically, this provision

58 INT. REV. CODE OF 1954, § 274(a)(1)(A). (Emphasis supplied.)
59 Rephan, *Is the Directly Related Test for Entertainment Expenses Really New?*, 17 J. TAXATION 365 (1962).
60 S. REP. No. 1881, 87th Cong. 2d Sess. (1962) (Supplemental and minority views).
61 S. REP. No. 1881, 87th Cong. 2d Sess. (1962).
62 *Ibid.*
63 Treas. Reg. § 1.274-2(c)(3).
64 Treas. Reg. § 1.274-2(c)(4), (5).
65 Treas. Reg. § 1.274-2(c)(3)(i), (ii), (iii).
66 Treas. Reg. § 1.274-2(c)(3)(iv).
67 Treas. Reg. § 1.274-2(c)(4).
68 *Ibid.*
69 Treas. Reg. § 1.274-2(c)(5).

allows deduction of expenses for a vacation trip awarded the taxpayer's retailer as winner of a sales-promotion contest.

To further clarify the "directly related" test, the regulations provide that an expenditure will not qualify if incurred under circumstances making active conduct of the business unlikely.[70] Several specific circumstances are cited as influencing this determination. If the taxpayer or his representative was not present at the entertainment activity, the indication is that such active conduct did not obtain.[71] Further, if distractions were substantial, such as a floor show at a night club, or if persons other than business associates were present, the inference is that the expenditure satisfied personal needs.[72] Finally, any fishing or hunting trip or yachting excursion are presumed to involve personal activities and militate against a finding that the activity was directly related to the active conduct of the business.[73] In order to deduct entertainment expenses involving these personal influences, the burden is upon the taxpayer to establish their business character by "clear evidence."[74]

In addition to the "directly related" test, which applies to entertainment activities generally, a relaxed rule is provided for those expenses incurred directly before or after "a substantial and bona fide business discussion." In such a case, the expense merely need be "associated with" the active conduct of the business.[75] This provision is directed at a relaxation period conducive to efficient participation in a business discussion, and is one of the exceptions to the disallowance of good-will entertainment under the new act.

Because an entertainment expense which is merely "associated with" must look to the business meeting it supports for its business validity, the regulations shift to the meeting to determine whether it was in sufficient proximity to business objectives to justify deduction. Two inquiries must be made: whether the meeting was a substantial and bona fide business discussion and whether the entertainment directly preceded or followed the meeting.[76]

A business discussion is substantial and bona fide if the taxpayer's business is actively pursued with an intent to secure income or some other specific business benefit (other than good will) immediately or at a definite or readily determinable future time, and if the principal character of the combined entertainment and business activities is active conduct of the taxpayer's business.[77] A convention meeting, officially scheduled as part of the program, will meet this description if the taxpayer's attendance expenses are "ordinary and necessary" and organized business activities are the principal activity of the convention.[78]

As a general rule, entertainment is not considered to have directly preceded or followed a business meeting unless it occurs on the same day.[79] As a rule of convenience, however, this will yield to circumstances indicating a different result. Thus, where the taxpayer's business associates arrive from out of town on the evening preceding a substantial, bona fide discussion, entertainment expenditures occurred on the night of arrival are deductible.[80]

Further, entertainment expenditures attributable to wives are deductible under the "associated with" test.[81]

Assuming that the entertainment-activity expense is deductible under § 162

70 Treas. Reg. § 1.274-2(c)(7).
71 Treas. Reg. § 1.274-2(c)(7)(i).
72 Treas. Reg. § 1.274-2(c)(7)(ii).
73 Treas. Reg. § 1.274-2(c)(7)(iii).
74 Treas. Reg. § 1.274-2(c)(7).
75 Int. Rev. Code of 1954, § 274(a)(1)(A).
76 Treas. Reg. § 1.274-2(d).
77 Treas. Reg. § 1.274-2(d)(3)(i)(a).
78 Treas. Reg. § 1.274-2(d)(3)(i)(b).
79 Treas. Reg. § 1.274-2(d)(3)(ii).
80 *Ibid.*
81 Questions and Answers furnished by the IRS, No. 24, March 30, 1963.

and either the "directly related" or "associated with" tets, the taxpayer must substantiate the following elements in the expense diary: (1) amount of each separate expenditure (except for aggregated expenses, such as daily taxi fares); (2) date of entertainment; (3) name and address of the place where the entertainment was furnished together with a designation (e.g., theater) of the type of entertainment; (4) business purpose or reason or nature of business benefit derived or expected by entertaining and the nature of any business discussion or activity; (5) business relationship of the taxpayer to the person entertained, including names, titles, and other appropriate designations.[82]

In making these entries, of course, the "separate payment," aggregation and pro-ratio rules apply.[83] In addition, the $25 limit requires that an expenditure exceeding this amount for an entertainment activity must be proved not only by the normal records but by an accompanying receipt or other document showing the amount, date, place and essential character of the expenditure.[84]

The above entries will support an entertainment activity expense "directly related" to business pursuits. Where the expense is claimed as a deduction under the "associated with" criteria, focus again shifts to the business meeting, and *in addition* to the above elements, the taxpayer must record: (1) the date and duration of the business discussion; (2) place of the discussion; (3) the nature of the discussion and the business reason derived or expected; (4) the identity of the persons entertained who participated in the discussion.[85]

2. *Entertainment Facilities.* — Many of the more flagrant expense-account abuses under prior law involved facilities used in connection with entertainment, such as automobiles, airplanes, yachts and hunting lodges.[86] Typically, excessive outlays for operating and maintaining such facilities were deducted although personal, rather than business needs were satisfied. Prior to enactment of the new "T & E" limitations, a taxpayer could deduct under § 162(a) that portion of expenses incurred in connection with the facility that business use represented of total use without regard to whether personal or business use predominated.[87] Further, allowable expenses included not only those directly related to the business but also good will entertaining bearing only a remote connection to business objectives.[88]

Under the new law, only general operating expenses, such as rent, utilities and depreciation are subject to deduction under the "facility" rules.[89] Thus, out-of-pocket expenditures such as those for food, drinks or gas incurred as part of an entertainment activity are not to be treated as a facility expense,[90] but are subject to the entertainment activity rules discussed in the preceding section.

In order to deduct the otherwise allowable operating expenses, the taxpayer must establish that the facility was used "primarily for the furtherance of the... business. . . ."[91] In addition, only those expenses that are "directly related to the active conduct of the business" may be deducted.[92]

A facility is used primarily in the business if the taxpayer establishes that business use comprised more than 50% of total use. The method of determining such use depends generally on the nature of the facility, the frequency and duration

82 Treas. Reg. § 1.274-5(b)(3).
83 Treas. Reg. § 1.274-5(c)(6).
84 Treas. Reg. § 1.274-5(c)(2).
85 Treas. Reg. § 1.274-5(b)(4).
86 The regulations define such a facility as "any item of real or personal property owned, rented or used by a taxpayer . . . in connection with entertainment. . . ." Treas. Reg. § 1.274-2(e)(2)(i).
87 International Trading Co. v. Comm'r, 275 F.2d 578 (1960).
88 Cleveland-Sandusky Brewing Corp., 30 T.C. 539 (1958).
89 Treas. Reg. § 1.274-2(e)(3)(i).
90 Treas. Reg. § 1.274-2(e)(3)(iii).
91 INT. REV. CODE OF 1954, § 274(a)(1)(B).
92 *Ibid.*

of each use for business as compared with personal purposes, the amount of expenditure for each use and any other relevant circumstance.[93]

In the case of an automobile, the taxpayer will qualify the facility for deduction if 50% of the total mileage during the year was incurred during business uses ordinary and necessary within the meaning of § 162(a).[94] Similarly, an airplane is used primarily in the business if over 50% of the annual flying time is attributable to ordinary and necessary business pursuits.[95]

The primary test for all other facilities, such as yachts and fishing camps, in determining whether they were used primarily for the furtherance of the business, is based on a comparison of "business use" days and "personal use" days.[96] Thus, a facility will qualify if more than 50% of the total calendar days of authorized use during the year were days of business use.[97] A day of business use results if the only use was ordinary and necessary. If both business and personal uses are involved during the same day, such as might result where the taxpayer's family uses the facilities, the day will be considered one of business use if a substantial and bona fide business discussion takes place. If the business use is only ordinary and necessary, a day of personal use will result. In computing primary use, those days on which the facility is not used are disregarded.[98]

Although the regulations provide these standard methods for establishing primary use, any other method will be permissible if the standard methods do not accurately reflect the character of the facility, as long as the alternative stresses the general elements mentioned above, namely, frequency and duration of each use and amount of expenditures involved.[99] Thus, a taxpayer may qualify a swimming pool as used primarily in the business if a large portion of the operating expenses are attributable to business use, although more days of personal use are involved than business use.

Having established that business use comprised in excess of 50% of total use of the facility, it would seem natural to assume that more than 50% of the expenses would necessarily be deductible. Such is not the case. Operating expenses are deductible only to the extent incurred during entertainment that passes the "directly related" test.[100] Thus, where a taxpayer uses a tennis court 45% of the time for entertainment "directly related," 15% for uses that pass only the ordinary and necessary tests, and 40% for personal uses, the facility is used "primarily for the furtherance of the business" but the deduction is only 45% of the operating expenses. In this respect, the proposed regulations do not accord with the Senate Report, where it was stated that entertainment expenses passing the "associated with" test would also be deductible.[101]

In order to substantiate that the facility was used primarily in the business, the taxpayer is again required to keep records, documenting: (a) for each use qualified as a "business use," amount, time, nature of the activity, nature of the business purpose and business relationship of the taxpayer to the person entertained,[102] and (b) for each personal use of the facility, a description including cost, date, number of persons entertained, nature of the entertainment (e.g., family use) and, if applicable, mileage or its equivalent.[103]

Again, a presumption exists that such facilities serve personal purposes, and

93 Treas. Reg. § 1.274-(e)(4)(i).
94 Treas. Reg. § 1.274-(e)(4)(ii)(a).
95 Treas. Reg. § 1.274-2(e)(4)(ii)(b).
96 Treas. Reg. § 1.274-2(e)(4)(iii).
97 *Ibid.*
98 *Ibid.*
99 Treas. Reg. § 1.274-2(e)(4)(i).
100 Int. Rev. Code of 1954, § 274(a)(1)(B).
101 S. Rep. No. 1881, 87th Cong. 2d Sess. (1962).
102 Treas. Reg. § 1.274-5(c)(6)(iii)(a).
103 Treas. Reg. § 1.274-5(c)(6)(iii)(b).

personal use will result unless the taxpayer keeps adequate records with the above elements documented. In this respect, the Revenue Service has suggested that the taxpayer maintain a general logbook providing entry space for (1) elements of each use, whether business or personal, as explained above, (2) entertainment activity expenses, (e.g., food, drinks) and the elements of the entertainment activity, and (3) records for incurred maintenance expenses, such as repairs, dock fees and fuel.[104]

3. Club Dues. — Club dues, initiation fees and assessments are to be treated in the future as "items with respect to facilities."[105] Thus, the question whether or not the club facilities were used primarily in furthering the business is to be answered in the same manner as for any entertainment facility.

Interesting questions are bound to arise under this section of the new act, as many country clubs owe high membership rolls to the deductibility of such expenses. The normal method provided by the regulations for determining "primary use" will be based on the "total calendar day" rule[106] explained above. Accordingly, a day will qualify as a business use if the only activity carried on by the taxpayer at the club was "ordinary and necessary" to business pursuits. If the club is used for a quiet "business meal," a business use directly related to the taxpayer's business results. If the taxpayer's family uses the club, a day of personal use will result unless a substantial and bona fide business discussion is held there during the same day. If the "personal use" days predominate during the year, no deduction will be allowed. In any event, the club expenses must be apportioned to uses "directly related" to the active conduct of the business.

In this latter connection, several techniques may evolve to insure some deduction. For example, a taxpayer belonging to two clubs may use one for business use and one for family use, thus insuring deductibility of one. Alternatively, some clubs may provide "split memberships" dividing the club facilities and capital assessments for each portion, in an attempt to segregate the disqualifying personal uses. In this respect, the IRS has indicated that if the family membership is independent of the taxpayer's membership, such an arrangement may qualify.[107] At any rate, it is desirable for the club member to engage in most of his business entertaining at the club to build up "business use" and a higher deduction.

An analogous problem dealt with by the new provision is the traditional business meal. In February, the IRS began receiving complaints from the National Restaurant Association that a false impression had been given the business community as to the status of the "goodwill business meal." Section 274(e)(1) expressly states that the meal will not be disallowed if incurred under circumstances "generally considered to be conducive to a business discussion." The regulations extend this exception to cocktails served in such an atmosphere and provide that business need not actually be discussed.[108] The atmosphere must be free from distracting influences such as floor shows or other entertainment, and the person furnished the meal must bear the normal business relationship to the taxpayer.[109]

On balance, it seems possible that the new restrictions may prove beneficial to private clubs, drawing income from entertainment that would formerly have gone to public restaurants, as the private clubs afford two advantages; first, the clubs usually provide a businesslike atmosphere closer to a "clear business setting," and second, business use of the club builds up the club dues deduction.[110]

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104 Questions and Answers furnished by the IRS on Substantiation, Ex. 5, Dec. 28, 1962.
105 INT. REV. CODE OF 1954, § 274(a)(2)(A).
106 Treas. Reg. § 1.274-2(e)(4)(iii).
107 Questions and Answers furnished by the IRS, No. 51, March 30, 1962.
108 Treas. Reg. § 1.274-2(f)(2)(i).
109 *Ibid.*
110 While the National Restaurant Association was complaining of declining revenues, a spokesman for private clubs indicated that they had experienced no such decline. Wall Street Journal, Feb. 14, 1963, p. 1, col. 5.

In substantiating club dues, the same general rules as those discussed with respect to any other "entertainment facility" apply.[111] The most workable plan would entail keeping an expense diary (perhaps at the club) to record the following elements: (a) for each business use, amount, time, nature of the activity (e.g., business meal), nature of the business purpose, including any business benefits attained or expected, and business relationship of the taxpayer to the person entertained,[112] and (b) for each personal use, amount, time, number of persons, and a notation indicating personal use.[113]

The IRS has indicated that the taxpayer may coordinate his expense diary and the periodic bills submitted by the club in order to provide an integrated record.[114]

4. Travel Expenses. — Travel expenses are expressly deductible under § 162(a) if "incurred while away from home" on business.[115] The general provisions of this section have again given rise to a number of interpretative problems. A brief survey of these problems will be made to understand the particular area affected by the new law.

Travel expenses, as used in the above cited section, means transportation, food, lodging and other incidentals,[116] which are deductible if (1) incurred away from home (2) on a temporary business assignment. They are to be distinguished from local transportation expenses, such as gas and oil, which are deductible if incurred in a trade or business regardless of whether other tests are met.

The IRS has contended for a long time that "away from home" requires an overnight trip to justify deduction.[117] Generally, the overnight rule would seem to serve as a valuable guideline for both taxpayers and revenue agents in weighing deductibility. Two recent cases have indicated, however, that the rule is not without exception. In *Williams v. Patterson,*[118] a conductor claimed deductions for hotel expenses incurred to enable him to rest during "release time," prior to returning home the same day. The court allowed the deduction, stating that where the circumstances are such that "it is reasonable for him (taxpayer) to need and obtain sleep or rest in order to meet the exigencies of his employment, his expenditures... are deductible. . . ."[119] In the second case, the Eighth Circuit reversed the Tax Court, allowing meals expenses to a building contractor who was required to travel around to various construction sites, even though the "overnight test" was not satisfied.[120]

The permanent nature of an "away from home" assignment has also operated to deprive taxpayers of the deduction by changing their "tax home" to the work situs. The tax court and most circuits follow an objective test recently restated by the IRS:[121] If the assignment is reasonably expected to last less than a year and actually does last less than the year, the assignment is temporary. The Ninth Circuit Court of Appeals has disagreed with this rule, applying a test more favorable to the taxpayer. The Ninth Circuit rule makes the dispositive issue a subjective one — did the taxpayer *know* that an indefinite assignment was probable?[122] This test has

111 Treas. Reg. § 1.274-5(c)(6)(iii).
112 Treas. Reg. § 1.274-5(c)(6)(iii)(a).
113 Treas. Reg. § 1.274-5(c)(6)(iii)(b).
114 Questions and Answers Furnished by the IRS on Substantiation, Ex. 4, Dec. 28, 1962.
115 INT. REV. CODE OF 1954, § 162(a).
116 Commissioner Caplin has announced that laundry, cleaning and pressing charges and taxi fares between the taxpayer's "away from home" lodging and first business call will be allowed in the future as a matter of audit practice. IRS News Release, March 30, 1962.
117 Treas. Regs. §§ 1.162-17(b)(3)(ii), (b)(4), (c)(2) (1958).
118 286 F.2d 333 (5th Cir. 1961).
119 *Id.* at 340.
120 Hanson v. Comm'r, 298 F.2d 391 (8th Cir. 1962).
121 Rev. Rul. 61-95, 1961 CUM. BULL. 21, 25.
122 Harvey v. Comm'r, 283 F.2d 491 (9th Cir. 1960), *reversing* 32 T.C. 1368 (1959).

been rejected again by the Internal Revenue Service and the Tax Court[123] and does not seem to be replacing the IRS test.

The new travel provisions affect trips based on both business and personal reasons. Formerly, a trip motivated primarily by business reasons qualified the traveler for full deduction of the travel expenses regardless of whether ancillary pleasure pursuits were engaged in during the trip.[124] Under the new act, the taxpayer is allowed to deduct only that portion of travel expenses that business activity represents in relation to total trip time.[125]

A number of exceptions in the regulations take most travel situations out of the limitations of § 274(c). Where total trip time is one week (seven consecutive days) or less, no allocation need be made.[126] In computing time spent on the trip, the day of departure is not included, but the return day is. Thus, a taxpayer who leaves on business travel on a Wednesday and returns the next Wednesday need not allocate his travel expenses. Similarly, trips during which less than 25% of total trip time is spent on nonbusiness pursuits are not affected.[127]

Under the normal reimbursement systems, further exceptions dilute the impact of the new section. Since the disallowance provisions only affect the person making the trip, the employer's deduction is not threatened by a reimbursed employee's personal activities while traveling.[128] In addition, the proposed regulations provide that where the individual incurring the expense, e.g., a reimbursed employee, does not have "substantial control over the arranging of the business trip," the disallowance provisions do not apply.[129] In this connection, an employee does not have substantial control over the travel unless he is a "managing executive" or "closely related" to his employer and even then, the presumption of control is rebuttable. Generally, control over the timing of the trip will not be considered "substantial control."

Finally, consistent with the purpose of the new travel provisions — i.e., disallowance of vacation travel expenses — the regulations provide that travel expenses will not be disallowed where the taxpayer can establish that obtaining a personal vacation was not a major consideration in making the trip.[130]

In those few cases where the traveler does not qualify under any of the above exceptions, travel expenses are deductible only to the extent that "business days" comprise total travel time.[131] A business day is a day in which the taxpayer is: (1) being transported to or from a business destination, (2) required by his employer to be present at a specified place (away from home) for a bona fide business purpose, (3) pursuing business during normal business hours, (4) at the business destination, on a stand-by basis, such as on a holiday or week end between recess and resumption of business activity.[132]

It is apparent that the IRS has provided a very liberal interpretation of § 274(c). As mentioned above, the numerous exceptions exempt a majority of taxpayers from the allocation provision. Even in those cases where allocation must be made, the guidelines are generous in determining that the day was a "business day." For example, under provision (2) in the preceding paragraph, if an employee is required to attend a specific and bona fide business meeting which lasts less than the normal day, this will be considered a business day even though the rest of the day is spent sight-seeing.

123 Leo M. Verner, 39 T.C. No. 77 (1963).
124 Treas. Reg. § 1.162-2(b)(1).
125 INT. REV. CODE OF 1954, § 274(c).
126 Treas. Reg. § 1.274-4(c).
127 Treas. Reg. § 1.274-4(d).
128 Treas. Reg. § 1.274-4(a).
129 Treas. Reg. § 1.274-4(e)(5)(i).
130 Treas. Reg. § 1.274-4(e)(5)(ii).
131 Treas. Reg. § 1.274-4(e)(i).
132 Treas. Reg. § 1.274-4(d) (2).

As under prior law, no deduction is allowable where the primary purpose of the trip is personal.

The elements of a business travel expense to be substantiated follow the same general lines as those discussed previously. Entries in the expense diary must include: (1) amount of each separate expenditure, such as lodging or transportation, except for items aggregated, (2) dates of departure and return and number of days spent on business, (3) locale visited, by name of town or other relevant designation, (4) business benefit derived or expected.[133]

In addition to the diary entries, documentation in the form of receipts or paid bills is required for any lodging expenditure while away from home.[134] Such a receipt should include the amount, date, place and character of the outlay.

5. Business Gifts — (a) Status of Gifts in General. — Deductibility of business gifts continues to be governed by the standards of § 162. As a general rule, the gifts are presumed to have been given for personal reasons until an affirmative showing is made that they are ordinary and necessary. Thus, proximity to business purpose and accepted practice in the industry are key factors in determining deductibility.[135] Under former law, no limit was set on the value of a deductible business gift.

Section 274(b) defines a business gift as any item excludable from the gross income of the recipient by virtue of § 102 and not excludable under any other section of the Code, and limits the deductibility for such an item to a $25 annual maximum. Under the new rules, a donor of business gifts may deduct only $25 per recipient of the aggregate value of all gifts during the year.[136] For purposes of this section, gifts to a wife having no independent business relationship to the donor are considered to be gifts to the husband in applying the annual limit.[137]

Where the donor is a partner, the $25 limit on deductibility is applied at the partnership as well as the partner level.[138]

As there is some overlapping between the entertainment and gift provisions where an entertainment-producing gift is made, the regulations provide certain jurisdictional rules for applying the proper limitations. Thus, any expenditure for packaged food or beverages to be consumed at a time later than the transfer is considered a gift.[139] Where tickets are given and the donor does not accompany the recipient to the entertainment, the taxpayer may elect to treat the expense either as entertainment or a gift, whichever is more advantageous.[140] Any other ambiguous expenditure is to be considered entertainment rather than a gift.

The limitation of § 274(b) does not apply to several classes of gifts to be encouraged as promotional items or on grounds of public policy. Thus, advertising novelties, such as letter openers or pens, costing less than $4, marked clearly with the donor's name and distributed generally as goodwill advertising are still deductible.[141] Similarly, point of sale promotion aids, aimed at stimulating sales of the donor's product are deductible if used on the recipient's premises.[142] Finally, length of service or safety awards, such as a watch or collar pin, costing less than $100 are still allowable expenses on grounds of public policy.[143]

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133 Treas. Reg. § 1.274-5(b)(2).
134 Treas. Reg. § 1.274-5(c)(2)(iii).
135 See Welch v. Helvering, 290 U.S. 111 (1933). See generally 4 MERTENS, FEDERAL INCOME TAXATION § 25.14 (1960 rev.).
136 INT. REV. CODE OF 1954, § 274(b).
137 Treas. Reg. § 1.274-3(e)(2).
138 Treas. Reg. § 1.274-3(e)(1).
139 Treas. Reg. § 1.274-2(b)(1)(iii)(b)(1).
140 Treas. Reg. § 1.274-2(b)(1)(iii)(b)(2).
141 INT. REV. CODE OF 1954, § 274(b)(1)(A).
142 INT. REV. CODE OF 1954, § 274(b)(1)(B).
143 INT. REV. CODE OF 1954, § 274(b)(1)(C).

The business gift has attained such an important position in our highly competitive economy that the size of the business favor accorded a purchasing agent may have as much significance as the relative merits of competing products.[144] The favor so accorded has been deductible as a general rule.[145] At times, the cases have struggled to inject a moral note by disallowing deduction, but only when the alleged gift was clearly a "kickback."[146]

To some extent, § 274 will put the forced "donor" of such business favors in a difficult position. If he does not continue to meet the business favors of competitors, he may lose his business; if he does, limitation of his deduction to $25 increases his financial burden, causing him to pare his profits further or to inflate the cost of his product. Since the limitations apply to all competing donors, however, the added financial burden of absorbing amounts in excess of the $25 limit may cause a curtailment in this type of "commissions." Although the Revenue laws are not generally charged with enforcing morality, § 274 may have such an effect.

One of the prevalent business practices that will be affected by the new section is the distribution of tickets to athletic or theatrical performances. Under the new rules, if such a gift is made to a recipient in his individual capacity, of course, the normal rules apply. If the gift is made to a corporate customer, however, some tracing is necessary to insure the deduction. If given to the corporation for the eventual use of a particular employee (or other associate of the enterprise), the gift is considered to have been made to the individual.[147] If the gift is made available to the corporation for the eventual use of an undesignated member of a large group of employees, however, it is considered to have been made to the corporation and the $25 limit is applied to the corporation as recipient.[148] This indirectness of the gift can only be overcome by the donor if it is reasonably practicable for him to ascertain the ultimate recipient of the gift.[149]

(b) Gifts to Widows of Employees. — The business gift limitation enacted by Section 274(b) may help to clarify one more area of the federal tax law currently plagued with uncertainty — the tax status of an employer's gratuitous payments to a deceased employee's widow.[150]

The Treasury accorded the recipient's exclusion of such amounts from an early date, but denied the employer-donor deduction.[151] Later, the Treasury allowed the donor to deduct amounts so paid as an "ordinary and necessary" business expense.[152] As this "loophole" came into frequent use, allowing the transfer of excessive amounts without tax, the government reversed its position, contending that the amounts were income to the recipient.[153] Judicial precedent on the question was strong, however, and forced the Service to stop litigation as to such payments under the 1939 Code.[154]

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144 In this connection, President Kennedy said in his message on expense account abuses that he was

> confident that business firms, now forced to emulate expense account favors of their competitors, however unsound or uneconomical such practices may be, will welcome the removal of this pressure. H. R. Doc. No. 140, 87th Cong. 1st Sess. (1961).

145 Dixie Machine Welding, Inc. v. United States, 207 F.Supp. 84 (D.C.E.D.La. 1962).

146 Estate of R. W. Lashells, T.C. Memo. Op., Dkt. 29357 (1952). The IRS has recently announced that deduction will not be allowed for any "kickback" which violates any federal or state law or regulation. Rev. Rul. 62-194, 1962 Cum. Bull. 46.

147 Treas. Reg. § 1.274-3(d)(2).

148 *Ibid.*

149 *Ibid.*

150 See *e.g.* Diehl, *Payments to Widows of Corporate Employees: Recent Cases and Rulings*, U. So. Cal. 1960 Tax Inst. 491; Yohlin, *Payments to Widows of Employees*, 40 Taxes 208 (1962); *Note*, 49 Va. L. Rev. 74 (1963).

151 T.D. 2090, 16 Treas. Dec. Int. Rev. 259, 267-68 (1914).

152 I.T. 3329, 1939-2 Cum. Bull. 153.

153 *E.g.*, Louise K. Aprill, 13 T.C. 707 (1949); Alice M. MacFarlane, 19 T.C. 9 (1952).

154 Rev. Rul. 58-613, 1958-2 Cum. Bull. 914.

Congress amended the Code in 1951 to make employee death benefits expressly deductible when based on a written contract.[155] § 101(b) of the '54 Code extended this exclusion to amounts paid in the absence of a contract.[156] Thus "employee death benefits" paid a widow after 1954 were excludable up to a $5,000 maximum.

Despite Revenue contentions that § 101(b) covered all employer payments to widows, the first courts to pass on the question under the '54 Code held to the traditional view. The new section failed to distinguish between gratuities given for reasons of sympathy and kindness and those given to discharge a quasi-contractual moral duty for employee morale. Seizing on this distinction and the retention of the section according exclusion to gifts, these courts held that § 101(b) did not apply to the former class of gratuities.[157] Thus, where the intention to bestow a "gift" appeared, exclusion still resulted under the '54 Code.

The IRS has contended that if the payments are gifts (as opposed to business gifts) in the hands of the recipient, then the employer should not be allowed a business deduction.[158] Various factors have combined to allow the employer the deduction, however, including: the social policy of not discouraging the gifts, running of the statute of limitations by the time the widow's treatment is determined,[159] and the fact that the employer, not in privity with the widow, has framed the enabling resolution in terms of compensation.

In 1960, the Supreme Court decided *Duberstein v. Commissioner*[160] in which the (non) taxability of a "gift" automobile was at issue. The car had been presented to the taxpayer by one for whom he had rendered "gratuitous" business favors. In holding the receipt to be income, the Court rejected the Commissioner's request for a more definite standard to measure such transfers, and stated that the controlling question was to remain whether the transferor intended a gift or compensation. The Court did add new elements to the question, stating that "gift" was to be construed not as a common law term applying to all gratuitous transfers, but in a more colloquial sense.

> [I]f the payment proceeds primarily from "the constraining force of any moral or legal duty"; or from "the incentive of anticipated benefit" of an economic nature, . . . it is not a gift. And, conversely, "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." . . . A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," ... "out of affection, respect, admiration, charity, or like impulses."[161]

In a series of post-*Duberstein* cases, the Tax Court has relied on the tenor of this discussion of "gift" to hold transfers not excludable.[162] In moving from its former position, the court has given emphasis to the corporate resolutions, which cast the payments in varying terms as compensation.

This position has been criticized as an undue extension of *Duberstein*.[163] In that case, the compensation factor was readily seen. In the typical widow-payment case, compensation is less obvious. Usually the decedent employee was fully compensated during his lifetime; the payments are not made to the one from whom the consideration flowed but to his widow. The Fourth and Sixth Circuit Courts

155 INT. REV. CODE OF 1939, § 22(b)(1).
156 INT. REV. CODE OF 1954, § 101(b).
157 Reed v. United States, 177 F.Supp. 205 (D.C.W.D.Ky. 1959); *aff'd. mem.*, 277 F.2d 456 (6th Cir. 1960).
158 *E.g.* Duberstein v. United States, 363 U.S. 278, 287 (1960).
159 Pelisek, *Conflict in the Widows' Cases Continues as the Supreme Court Denies Certiorari*, 18 J. TAXATION 118, 119 (1963).
160 363 U.S. 278 (1960).
161 *Id.* at 285.
162 *E.g.* Estate of Mervin G. Pierpont, 35 T.C. 65 (1960); Estate of Martin Kuntz, Sr., 19 CCH TAX CT. REP. 1379 (1960); Estate of Rose A. Russek, 20 CCH TAX CT. REP. 123 (1961).
163 Yohlin, *supra* note 150 at 214.

of Appeals have apparently been convinced by these distinctions and have reversed two of the tax court decisions as clearly erroneous.[164]

The money is not usually given solely out of consideration of the widow's plight, but depends on the past employment relationship of the husband and the payor. It seems that the payments are made for a number of reasons, including appreciation of the decedent's loyal service, and a desire on the part of the corporation to acknowledge this loyalty in a manner enabling the widow to cope with her less secure position. The Second and Third Circuits have agreed with the tax court interpretation of *Duberstein* in holding the payments taxable.[165]

Prior to the 1962 Revenue Act, the corporate payor has been able to draft a corporate resolution evidencing a hybrid intent in respect to the payments. Usually, both compensation and gift language appear. As a result, the corporation has been able to deduct the payments as salary or a business gift and the recipient has been allowed to exclude the amounts from gross income by relying on the gift language.

The new Act's business gift limitation will make this double exemption more difficult and presents the corporate draftsmen with a dilemma. The IRS will probably take inconsistent positions to avoid double exemption of the amounts and, unless the salary factor is stressed in the resolution, the corporate deduction is jeopardized. Naturally, to the extent the salary characterization is emphasized by the payor, the widow's already tenuous position is threatened. Thus, it is likely that more lucid corporate resolutions will accelerate the current trend of holding the widows' payments taxable.

To insure deduction, the payor will probably dwell on compensation elements, both in characterizing the payments and in their computation. On the other hand, if the corporation is willing to sacrifice its deduction in deference to beneficial tax treatment for the widow, a detached evaluation of her circumstances and payments based on her needs would seem most persuasive.[166]

For payments of $5000 or less, favorable tax treatment for both parties is still possible if the payments are "employee death benefits" within the meaning of § 101(b). That section accords a $5000 exclusion to the recipient of otherwise taxable payments. The payor may deduct the amounts under §§ 404(a)(5) and 162(a).[167] In addition to a precise definition of the payment as "employee death benefits" in the minutes, treatment of the payments by the recipient in a manner consistent with this section should favorably determine their status.

Possibly, transfers in excess of $5000 may be attempted through more than one corporate resolution. Since beneficial treatment for amounts under $5000 is assured by § 101(b), the excess may be cast by a second resolution in traditionally ambiguous terms in hopes that different determinations may continue to benefit both parties. In the jurisdictions that presenty allow the widow to exclude the payments, a second resolution of this type may succeed.

If Section 274 succeeds in taxing widow payments to one of the parties consistently, it is possible that this onetime loophole may be supplanted with different vehicles of payment. To the extent that this achieves tax equity by eliminating transfers not covered by the original policies underlying exclusion, the result seems desirable.

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164 Poyner v. Comm'r, 301 F.2d 287 (4th Cir. 1962), *reversing* Estate of Mervin G. Pierpont, *supra* note 162; Estate of Kuntz v. Comm'r, 300 F.2d 849 (6th Cir. 1962), *cert. denied,* 31 U.S. Law Week 3165 (U.S. Nov. 13, 1962).

165 Gaugler v. United States, 312 F.2d 681 (3rd Cir. 1963); Martin v. Comm'r, 305 F.2d 290 (3rd Cir. 1962); Smith v. Comm'r, 305 F.2d 778 (3rd Cir. 1962), *cert. denied,* 31 U.S. Law Week 3165 (U.S. Nov. 13, 1962).

166 "A gift in the statutory sense, on the other hand, proceeds from a 'detached and disinterested generosity,' . . . 'out of affection, respect, admiration, charity or like impulses.'" Duberstein v. Comm'r, 363 U.S. 278, 287 (1960).

167 Section 404(a)(5) allows deduction of amounts paid as a death benefit if such amounts are "ordinary and necessary" under §§162 or 212 and are not expressly deductible under any other section of the Code. INT. REV. CODE OF 1954, § 404(a)(5).

As regards other types of business expenses still deductible under § 274, business gifts, to be deductible up to $25, must be recorded in the expense diary (or similar record). The following elements of the expense should be noted: cost, date of the gift, description of the gift, business purpose and benefit expected to be derived from the gift, and name of the donee with his business relationship to the donor.[168]

In order to maintain accurate integrated records, it would seem appropriate to keep a section of the regular expense diary available for gift entries.

C. *Special "Employment" Substantiation Methods.*

Congress, recognizing the tremendous burden on the IRS necessarily involved in overseeing the new record-keeping requirements, and desiring to defer to those bona-fide accounting systems used by employers for internal control, has provided methods for shifting control responsibility from the Service to the employment relationship in certain cases.[169] Implicit in these methods is the idea that arms-length profit seeking induces employers to limit expenses to those necessary in conducting the business.[170] In certain situations, such as an inadequately run audit system or where a stockholder employee is participating,[171] the arms-length circumstances do not obtain and the deference is not accorded.

1. Employer-Employee Relationship. — Initially, it should be kept in mind that where expenses incident to travel, entertainment or gift items are incurred as a benefit to the employee and treated as compensation to him, their value is includable in the recipient's gross income.[172] As a compensation deduction under Section 162, the new limits are not applicable.

Where an employee makes travel, entertainment or gift expenditures for the sole benefit of the employer and is reimbursed, amounts thus received need not be reported as income by the employee if an "adequate accounting" is made to the employer and the reimbursements equal the expenses.[173] If the reimbursements exceed expenses, the excess is taxable to the recipient.[174] Conversely, amounts expended by the employee in excess of employer allowances must be substantiated in the regular way if the employee seeks to deduct the deficit.[175] In addition to the regular substantiation records — i.e., "adequate records" or an acceptable substitute, the employee must annex a statement to his tax return showing (1) total reimbursements, (2) nature of his occupation, (3) number of days away from home on business, and (4) the total amount of expenses paid or incurred.[176]

An "adequate accounting" to the employer parallels the "adequate records" system that the employee would otherwise be required to maintain for the Internal Revenue Service. Thus, the employee must submit to his employer an expense diary in which the elements of each affected expense have been recorded "at or near" the time of the expenditure.[177] The employee's self-serving statement and "other sufficient evidence," an acceptable substitute where the taxpayer's records are subject to IRS scrutiny, will not constitute an adequate accounting to the employer.[178] In order to meet the administrative deference this section permits, the employer's system must meet certain standards of internal control, such as

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168 Treas. Reg. § 1.274-5(b)(5).
169 Treas. Reg. § 1.274-5(e), (f), (g). This approach was contended for by many of the witnesses at the substantiation regulation hearings. Wall Street Journal, Dec. 5, 1962, p. 3, col. 1.
170 Treas. Reg. § 1.274-5(e)(5)(iii).
171 Treas. Reg. § 1.274-5(e)(5)(ii).
172 INT. REV. CODE OF 1954, § 274(e)(4).
173 Treas. Reg. § 1.274-5(e)(2)(i).
174 Treas. Reg. § 1.274-5(e)(2)(ii).
175 Treas. Reg. § 1.274-5(e)(2)(iii).
176 Treas. Reg. § 1.274-5(e)(2)(iii)(a).
177 Treas. Reg. § 1.274-5(e)(4).
178 *Ibid.*

approval of expense records by a responsible employee other than the person incurring the expense.[179]

The relief granted by this section will not result where the employer's control system is not adequate, the employee fails to satisfy the requirements of an adequate system, or the employee is related to the employer within the meaning of § 267(b).[180] In these cases, the employee must file a statement appended to his return, disclosing total reimbursements, occupation, days away from home on business and total expenses incurred, broken down into convenient readings. Further, a properly kept expense diary (or substitute method of "adequate records") must be retained to support the deductions.

Pursuant to authorization by the new section, the IRS has gone a step further in accommodating efficient employer record systems for travel expenses. T.I.R. 437 provides that if an employer grants reimbursement or per diem allowances not exceeding $25 per day for travel expenses, these amounts will be deemed substantiated if the payments are limited to those expenses ordinary and necessary to the business *and* the elements of time, place and business purpose are substantiated.[181] A plan qualifies as limiting expenses to those "ordinary and necessary" if adequate controls are provided such as approval of expenses by a responsible employee and the allowances evidence a bona-fide attempt to approximate actual costs.

In addition to the travel expense provisions, "ordinary and necessary" transportation allowances by the employer not exceeding 15¢ per mile will satisfy the "amount" substantiation.[182] In this connection, place and business purpose entries supporting per diem allowances will also satisfy transportation "proof" requirements.

An employee owning stock representing 10% or more of the company's equity capital may not utilize the per diem provisions but can use the mileage allowances.[183]

2. *Independent Contractor-Client Expense Systems.* — Because of ethical restrictions on lawyers' advertising,[184] it might be expected that the Internal Revenue Code would recognize an extended need on the part of lawyers to engage in good-will entertaining. Such has not been the case, however. The attorney stands on no better ground than any other taxpayer in this respect, except as such a need may be implicit in a factual determination of what is "ordinary and necessary." Accordingly, the new limitations of § 274 apply to the lawyer as well as to those in other vocations. Thus, under prior law, an attorney returning from military service was allowed to deduct a substantial portion of cocktail party expenses where the evidence established that the parties were given to enable the taxpayer to renew former business contacts.[185] Such a result will be unlikely under the new act, as the principal character of the entertainment was social rather than business.

Of course, the traditional business meal furnished a continuing client during a normal business day will continue to be deductible.[186] Similarly, the normal rules in regard to club dues and assessments apply to attorneys.[187]

An attorney paying travel, entertainment or gift expenses incurred on behalf of a client is considered to have loaned the money to the client.[188] Consequently, the payments are not deductible and reimbursements for the outlay are not includable

179 Treas. Reg. § 1.274-5(e)(5)(iii).
180 Treas. Reg. § 1.274-5(e)(5).
181 T.I.R. No. 437, Dec. 28, 1962.
182 *Ibid.*
183 *Ibid.*
184 Canons of Professional Ethics, Canon 27.
185 Robert R. Williams, 24 P-H TAX CT. REP. & MEM. DEC. 311 (1955).
186 Proposed Treas. Reg. § 1.274-2(f)(2)(c).
187 See text accompanying note 106 *supra*.
188 Reginald G. Hearn, 36 T.C. 672 (1961).

in income.[189] Under former law, *Cohan* permitted the vague methods of estimating and reconstructing such expenses.

Under the new provisions, an attorney[190] is required to substantiate reimbursed travel, entertainment and gift expenditures by either the "adequate records" or "other sufficient evidence" methods.[191] Failure to do so makes the reimbursed amounts includable in income.[192]

If an attorney makes the prescribed records available to the client as a condition to reimbursement, two consequences follow: first, the entertainment expenses that are "ordinary and necessary" need not meet the new "proximity to business objectives" tests of Section 274 to allow the lawyer to exclude the reimbursement;[193] second, in order to save his own deduction, the client must retain the records made available by the attorney.[194] In this manner, the new provisions allocate the record keeping responsibility in the manner that the parties have agreed upon. The attorney has primary responsibility for establishing the expense item. Failure to do so subjects a proportionate amount of reimbursements to income treatment. Where the attorney furnishes substantiation in one of the prescribed methods, this primary responsibility shifts to the client.[195]

Where the attorney has supported his client-motivated expenditures in making an accounting to the client which meets the prescribed standards, the new section does not require that the expense meet "proximity to business objective" tests in order to allow the attorney an offset against reimbursements. Realistically, the attorney acts as a conduit between the party entertained and the client-payor. Since the client is not excused from meeting the "proximity" test and will not be able to substantiate the "business benefit" elements,[196] his deduction will not be allowed. The regulations governing this situation indicate that, in view of the client's judgment that this expense was "necessary," a double disallowance of the deduction (offset) is too harsh. An automatic control on "expense account living" for the attorney is present in that the client will not likely tolerate personal expenditures on which he is taxable.

In this latter connection, an interesting problem may arise. An attorney incurring entertainment expenses on behalf of the client is acting with the latter's authority — express or implied. Under prior law and the liberal interpretation given "ordinary and necessary," the attorney could act in the absence of the client in making goodwill expenditures. If the client did not agree with the attorney's judgment, the entertainment would still only cost him the difference between the expenditure and his deduction. Under the new law, the client may still deem such an entertainment expense necessary, but the conscientious attorney will be less likely to act with implied authority as he may derive a personal benefit by participating in the entertainment activity at the (taxable) expense of the client.

This problem could present a strain on the attorney-client relationship. Because of his fiduciary nature of his duty to the client and good common business sense, the attorney will be placed in an awkward situation. If the client is an important one, the lawyer will not likely press his claim for reimbursement. In

189 Henry F. Cochrane, 23 B.T.A. 202 (1931).
190 "Attorney" is used throughout this section for convenience. The same rules apply to any independent contractor.
191 Treas. Reg. § 1.274-5(g)(2).
192 *Ibid.*
193 Treas. Reg. § 1.274-5(g)(3).
194 Treas. Reg. § 1.274-5(g)(4).
195 *Ibid.*
196 In this case, since the attorney's exemption from "directly related" does not transfer to the client, and the latter will not be able to produce records proving such use by the attorney, the client will not be able to deduct the amounts.

such a case, amounts expended may possibly be deducted as a § 166 bad debt,[197] a § 162 business expense[198] or a § 165 loss.[199]

IV. Conclusion.

The regulations published and proposed by the IRS have given the new "T & E" limitations a form that promises to approach the Administration's goal of abolishing expense account living. Congressional recognition of the proposition that these expenses play a valid commercial role in certain circumstances does not appreciably alter this general impression of the new section.

In attempting to combat deductible living, the new law has taken a two pronged attack. Most important, of course, is abolition of the *Cohan* rule. Arbitrary year end "estimates," upon which inaccuracy and even fraud thrived, are replaced by a requirement that the taxpayer substantiate deductions in a business-like manner. In addition, the substantive proposals aim at correcting weaknesses within the various types of expense that have made personal expenses deductible. Entertainment expenses will be deductible only if inextricably bound up with active conduct of the business. Facility expenses will be deductible only to the extent that proximate business objectives are met and documented. Travel expenses for personal vacations are disallowed. Personal gifts given in the name of the business enterprise are deductible only to a $25 maximum, regardless of how necessary or proximate to business objectives.

Either fortuitously or otherwise, Commissioner Caplin has won a major IRS victory through his handling of the "T & E" regulations. Widespread objection of late 1962 to the detail of the substantiation regulations has changed to praise for liberal Treasury interpretation of the section. As a result, the IRS has engendered a minimum of dissatisfaction on the part of commercial interests while gaining its long awaited tool for combating expense account abuses. And, possibly more important, the Revenue Service has assumed a role of protector of equity among all classes of taxpayers — an image of inestimable worth to the self-assessment system.

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197 Reginald G. Hearn, 36 T.C. 672 (dictum).
198 Int. Rev. Code of 1954, § 162(a).
199 Int. Rev. Code of 1954, § 165.