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IRS, Expense Accounts, and the Cohan Rule—An Exercise in Loophole Closing

Bruce Graves

University of Nebraska College of Law, graves@brownwinick.com

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Nobody was ever meant
To remember or invent
What he did with every cent
Robert Frost

IRS, EXPENSE ACCOUNTS, AND THE COHAN RULE—
AN EXERCISE IN LOOPHOLE-CLOSING

I. INTRODUCTION

Travel and entertainment expenses, as tax deductions, were the subject of sweeping changes in the Revenue Act of 1962. The enactment was Congress' answer to a problem which had troubled the Internal Revenue Service since the early forties. Shortly after the appearance of the new statute, the IRS laid out its own set of regulations on the same subject. The new rules, as enacted by Congress and supplemented by the Service, conveyed the message to American taxpayers that approximations in travel and entertainment deductions would no longer be allowed. The new rule: Substantiate the expenditure or face complete disallowance.

The purpose of this article is to scrutinize the new statute and regulations and, from an historical standpoint, to ascertain the underlying reasons behind their promulgation. The rules will also be inspected in an analytical autopsy to determine whether they represent a fair and workable guide for claimants of T & E deductions.

II. PRE-COHAN DAYS

The Revenue Act of 1913 was silent on the matter of travel and entertainment expenses. One writer points out, however, that the deduction for traveling expenses was included in the "catch-all phrase 'necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses.'" This same language was believed sufficient again when Congress enacted the Revenue Act of 1916.

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Then, in the Revenue Act of 1921, Congress gave its legislative sanction to the deduction for traveling expenses by specifically enumerating them in the act. The deduction was phrased in its present language, in that "ordinary and necessary" business deductions were said to include "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business. . . ." Until last year, however, deductions for entertainment were not specifically listed in the Code, their deductibility being based upon the concept of "ordinary and necessary" business expenses.

An examination of an early IRS regulation (under the Revenue Act of 1918) indicates that limited deductions were allowed for traveling expenses even before Congress listed them in the Act. The taxpayer was allowed to deduct what we now refer to as "transportation" expenses incurred on a business trip, but was refused a deduction for his meals and lodging while away from home. Meals and lodging were considered to be personal living expenses, which continued to be personal whether the taxpayer was at home or away on business. The regulation allowed an individual to deduct only the costs of his "railroad fares," provided, of course, that he was not fully reimbursed for them.

In a 1920 Treasury Decision amending the earlier regulation, the IRS authorized, in addition to the deduction for "railroad fares," claims for meals and lodging while away from home to the extent that such expenses were "in excess of any expenditures ordinarily required for such purposes when at home." Under this "broader view of the situation," the Service noted that "a certain amount expended while on a business trip may be attributed solely to the

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6 Revenue Act, ch. 136, § 214, 42 Stat. 239 (1921).
7 Ibid.
9 Treas. Dep't, United States Internal Revenue, Regulations 45 Relating to the Income Tax and War Profits and Excess Profits Tax under the Revenue Act of 1918 (1920 ed.): "Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. . . . If the trip is on business, the railroad fares become business instead of personal expenses, but the meals and lodging continue to be living expenses and are not deductible in computing net income."
10 Ibid.
12 Ibid.
business,"^{14} but could not disregard the fact that "wherever a person may be, at home or abroad, he necessarily must have personal and living expenses which in any event are not deductible."^{15} The traveling taxpayer, therefore, could deduct the amount of expense incurred for meals and lodging away from home over the value attributed to such items while at home. It is significant that this attitude prevailed even before the express language providing for deductibility of traveling expenses in the Revenue Act of 1921.

But more important are the substantiation and other reporting requirements which the 1920 Treasury Decision imposed on taxpayers who sought to claim the traveling expense deduction. The deduction was required to be substantiated by "records showing in detail the amount and nature of the expenses incurred."^{16} In addition, the taxpayer claiming the deduction was required to submit a statement with his return showing:

1. the nature of the business in which engaged; 2. number of days away from home during the calendar year on account of business; 3. number of members in taxpayer's family dependent upon him for support; 4. average monthly expense incident to meals and lodging for entire family, including taxpayer himself when at home; . . . 6. total amount of expenses incident to meals and lodging while absent from home on business during taxable year; 7. total amount of excess expenditures incident to meals and lodging while traveling on business and claimed as a deduction; 8. total amount of other expenses incident to travel and claimed as a deduction.

The taxpayer was required to show "not only the cost of meals for his family, but the entire cost of maintaining his household,"^{18} including such items as "groceries, water, rent, gas, light, and any other necessary expenses. . . ."^{19}

The policy of the Service in applying these provisions was to disallow the item if it were unsubstantiated.\(^{20}\) In one case, where the taxpayer relied solely on estimates of his traveling expenses, the Service disallowed the entire deduction, emphasizing the failure of the taxpayer to "furnish the detailed information required. . . ."\(^{21}\)

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16 T.D. 3101, *supra* note 11. (Emphasis added.)
Then in 1922, probably in response to the Revenue Act of the preceding year, a Treasury Decision stated that "if the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, become business instead of personal expenses."22 As a result, the taxpayer was no longer required to submit information with his return concerning his expenses of family upkeep. The recordkeeping rules providing for substantiation, however, were left essentially intact, requiring "records showing in detail the amount and nature of the expenses incurred."23

Unlike traveling expenses, a taxpayer's claim for entertainment deductions could find no support from a specific provision of the statute. The basic problem encountered was the same as that which prevailed until recently—determining whether a particular entertainment expenditure was a personal or business expense.24 The line of demarcation was often difficult to perceive, and IRS precedent provided little help since each case turned upon its own particular facts.25

The policy of the courts during this period seems to have corresponded closely with that of the IRS. An unsubstantiated traveling or entertainment expense was usually disallowed,26 even though it could be shown that the taxpayer had actually spent some amount for business purposes.27 The language of the Board of Tax Appeals in Barnett Weiss28 was typical of the prevailing attitude, and was often cited in later opinions:

The Board is cognizant of the fact that every detail of a traveling expense account is difficult to keep and prove, and for that reason the Board is prone to give considerable latitude in the matter of evidence tending to prove such amounts. However, there

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23 The taxpayer was required to substantiate "(1) the nature of the business in which engaged; (2) number of days away from home during the taxable year on account of business; (3) total amount of expenses incident to meals and lodging while absent from home on business during the taxable year; (4) total amount of other expenses incident to travel and claimed as a deduction." Id. at 246.
26 See W. J. Monro, 19 B.T.A. 71 (1930); Leon Dashew, 16 B.T.A. 1 (1929); Frishkorn Real Estate Co., 15 B.T.A. 463 (1929); George B. Friend, 8 B.T.A. 712 (1927); Robert H. Champlin, 1 B.T.A. 991 (1925).
27 See Walter P. Coleman, 8 B.T.A. 1126 (1927); Sam Israel, 3 B.T.A. 663 (1926); Edwin Schlossberg, 2 B.T.A. 663 (1925).
28 3 B.T.A. 228 (1925).
must be something more than a bare estimate to support such a deduction. The burden of showing the incorrectness of the Commissioner’s determination is upon the taxpayer, and the bare assertion of an estimate in matters of expenses which can in all probability be proven with some degree of accuracy is not sufficient proof.\(^{29}\)

In a similar case,\(^{30}\) where the taxpayer determined the amount of his traveling expenses by the difference in the amount of money in his pocket when he left and when he returned, the Board disallowed the entire claim, even though there was “no doubt that the petitioner did make expenditures which . . . he was entitled to deduct. . . .”\(^{31}\)

The correct procedure for substantiating deductions was indicated in James F. Coleman.\(^{32}\) There the taxpayer had kept a memorandum book and each week had recorded the expenses incurred in entertaining prospective customers. Without opinion, the Board reversed the deficiency determination of the Commissioner.\(^{33}\)

The substantiation rules set down by the new statute and regulations are, therefore, not really new at all. Taxpayers were presented with the recordkeeping requirement during the very infancy of the tax laws. Had it not been for the intervention of the Cohan\(^{34}\) case into the tax law, substantiation of travel and entertainment items as a prerequisite to deductibility might have grown up as a matter of course.

III. THE COHAN ERA

Cohan v. Commissioner,\(^{35}\) decided in 1930, ushered in a new era for claimants of travel and entertainment deductions. To oppose a union’s efforts to force a “closed shop” upon the cast of his plays, George M. Cohan, after opening a show in Boston, made repeated trips to New York and brought back a complete new cast and chorus each week. In the course of his recruiting, he “found it necessary . . . to entertain the members of the cast and to provide lunches for them during rehearsals in order to keep them . . . and was obliged

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\(^{29}\) Id. at 230. See also M. T. Perkins, 12 B.T.A. 49 (1928); Walter P. Coleman, 8 B.T.A. 1126 (1927); Sam Israel, 3 B.T.A. 663 (1926).

\(^{30}\) Id. at 50.

\(^{31}\) Id. at 50.

\(^{32}\) 3 B.T.A. 885 (1926).

\(^{33}\) Ibid.

\(^{34}\) Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

\(^{35}\) Ibid.
to spend larger sums than usual in tips.” Similar expenditures were made for the entertainment of critics. In neither instance did Cohan keep expense account records:

The Board of Tax Appeals, in accordance with the earlier decisions, disallowed the T & E deductions on the ground that the amounts claimed were mere estimates, and there was no way of distinguishing between personal and business expenditures. On appeal, however, the decision as to travel and entertainment expenses was reversed. The Court of Appeals, emphasizing the refusal of the Board to allow any deduction whatever, notwithstanding their finding that large sums were spent, gave us the frequently-quoted language of Judge Learned Hand:

Absence certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board’s personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance and it was wrong to refuse any. It is not fatal that the result will inevitably be speculative; many important decisions must be such.

The host of subsequent cases employing Cohan in allowing a wide range of deductions illustrate the appeal of its sympathetic attitude underlying the “ameliorating effect” upon the taxpayer who failed to keep an adequate set of records. Moreover, the compromising result of the doctrine spread from the travel and enter-

38 Cohan v. Commissioner, supra note 34.
39 Id. at 543-544. “There are few, if any, cases more cited by the courts in tax proceedings.” Kramer, Estimated Income and Expense in the Tax Law, 32 Taxes 906 (1954).
tainment expense area into cases ranging from the allocation of income from sources within and without the United States\textsuperscript{41} to the valuation of money or money's worth for estate tax purposes.\textsuperscript{42} Because its application and inclusive scope grew at a rate not contemplated by even the most avid of its early proponents,\textsuperscript{43} rationalizations such as the following rallied to its defense:\textsuperscript{44}

As to the rule itself, the frequency of its use has attested to its wisdom, and established it as "settled." . . . Perhaps the frequent citations of the Cohan case are now merely evidence of the fact that there is now authority for what before was considered merely common sense and good logic.

Richard A. Sutter,\textsuperscript{45} decided in 1953, imposed one of the few limitations upon the Cohan principle by holding that amounts attributable to the taxpayer and his family spent in the course of entertaining customers or clients were not deductible. Such costs are, the court reasoned, "at least if not incurred while away from home in the pursuit of one's business, . . . personal expenditures," and as such, cannot be deducted.\textsuperscript{46}

The steps in the application of the Cohan doctrine were two-fold. The taxpayer first had to establish that he had actually made some payments, and second, he was required to show that at least some part of the expenditures was made for legitimate business purposes.\textsuperscript{47} The court would not engage in naked estimation, for under the Cohan rule, it was reasoned, assurance that the amount claimed was spent or incurred for the stated business purpose was

\begin{itemize}
\item \textsuperscript{41}Muir v. Commissioner, 182 F.2d 819 (4th Cir. 1950).
\item \textsuperscript{42}D. G. McDonald Trust, 19 T.C. 672 (1953); Paul Rosenthal, 17 T.C. 1047 (1951).
\item \textsuperscript{43}See O'Dwyer v. Commissioner, 266 F.2d 575 (4th Cir. 1959); Finley v. Commissioner, 255 F.2d 128 (10th Cir. 1958); Silverman v. Commissioner, 253 F.2d 849 (8th Cir. 1958); John A. Guglielmetti, 35 T.C. 668 (1961); Cleveland-Sandusky Brewing Corp., 30 T.C. 539 (1958); Henry Cartan, 30 T.C. 308 (1958); Herman J. Romer, 28 T.C. 1228 (1957). Moreover, "the [Tax] Court uses the memorandum decisions classification where the decision is strictly one of facts relating to a limited number of cases, or where a question of law is involved which has been decided previously by the Tax Court and followed in many decisions and upheld in the Circuit Courts. A great number of cases discussing the Cohan rule are reported in memorandum decisions." Gluck, \textit{How Cohan Works: Allowance of Business Expense Deductions When No Exact Records Are Kept}, 6 Rutgers L. Rev. 375 n.21 (1951-1952).
\item \textsuperscript{44}Gluck, supra note 43, at 400.
\item \textsuperscript{45}21 T.C. 170 (1953).
\item \textsuperscript{46}Id. at 173.
\item \textsuperscript{47}See Gluck, supra note 43, at 380.
\end{itemize}
a prerequisite to estimating the amounts spent. Until it had that assurance, the court could not be required to estimate, even though the estimate might have been affirmed. 48

On the basis of the evidence thus presented, the Commissioner or the Tax Court would then determine the amount of the allowance, the problems and uncertainties being resolved against the taxpayer for his own shortcomings. The determination of the amount of the deduction was usually governed by the credibility of the taxpayer's testimony, the statements of witnesses, the type of the particular expense, the ease with which a set of records could have been kept in the situation, and the effectiveness of the taxpayer's counsel in marshalling and presenting the evidence. With so many factors, the resulting sum was usually unpredictable. 49

During these same years, the policy of the Internal Revenue Service evolved from acquiescence in the Cohan doctrine 50 to exhortation of strict substantiation. 51 Immediately prior to the enactment of section 274, rules could be found distinguishing between personal and business entertainment expenditures, 52 advocating ac-

48 "[T]he basic requirement is that there be sufficient evidence to satisfy the trier [of facts] that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose. Until the trier has that assurance from the record, relief to the taxpayer would be unguided largesse." Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957).

49 See Gluck, supra note 43, at 397; Id. at 398: "[P]ercentages as low as 5 percent and as high as 90 percent have been employed." Another author has determined that "in seven cases . . . selected at random . . . the ratio of the total amount of travel and entertainment expenses allowed by the Tax Court to the total amount claimed by the taxpayer was 24 percent." Perkins, Recommendations for Preventing Disallowance of Expenses for Travel and Entertainment, 4 J. TAXATION 10, 13 (1956).

50 Rev. Rul 54-195, 1954-1 CUM. BULL. 47. Although cautioning that "some taxpayers are erroneously claiming personal, living, or family expenses as business deductions," agents were instructed to "exercise careful judgment which will permit reasonable determinations . . . ." Id. at 48. The ruling then announced: "Disallowing amounts claimed for such items merely because there is available no documentary evidence which will establish the precise amount beyond any reasonable doubt ignores commonly-recognized business practice as well as the fact that proof may be established by credible oral testimony." Id. at 49. The ruling was termed a "forceful restatement of the principles of the Cohan rule in its application at the administrative level." Kramer, supra note 39, at 908.


curate and detailed recordkeeping,\textsuperscript{53} and differentiating between certain types of employees.\textsuperscript{54}

The stricter substantiation requirements laid down by the Service had little effect, however, so long as taxpayers could point to \textit{Cohan} and the volumes of decisions in concurrence. Account books and diaries were pushed aside as too bothersome, and it was even argued that strict record-keeping requirements would stifle the government's realization of revenue from transactions which were the direct result of the T & E expenditures.\textsuperscript{55} Accordingly, the IRS began to realize that its substantiation objective could never be achieved "as long as the Cohan case continue[d] to be an integral part of the law."\textsuperscript{36}

**IV. THE PROBLEM**

Abuse of travel and entertainment deductions under the \textit{Cohan} doctrine first became noticeable about the period of World War II,\textsuperscript{57} and continued to grow until taxpayers were deducting everything from safaris to Africa\textsuperscript{58} and trips to the French Riviera\textsuperscript{59} to cans

\textsuperscript{53} Rev. Rul. 60-120, 1960-1 \textsc{Cum. Bull.} 83 required an employee to submit to his employer a detailed expense account statement, showing: "(1) the date and place of travel; (2) cost of transportation; (3) number of days away from home overnight; (4) an itemized statement showing total costs incurred for meals, lodging, and miscellaneous business expenditures, such as cab fare, telephone, etc.; and in connection with large or exceptional expenditures supporting documents, such as receipts."

\textsuperscript{54} Treas. Reg. § 1.162-17(c) (1958). Where the employee accounted to his employer, and his reimbursements equalled his expenses, he did not have to report his expenses for travel or entertainment on his return. Where he was not required to account to his employer, he was instructed to submit a statement with his return showing total reimbursements received, nature of his occupation, number of days away from home on business, total amount of expenses paid or incurred by him for his employer, broken down into categories such as meals and lodging, transportation, entertainment, and other expenses.

\textsuperscript{55} To saddle taxpayers with strict record keeping in many cases might tend to stifle the ability to earn the income. Wisdom suggests that a liberal attitude should prevail with respect to the expense of maintaining the fecundity of the goose that lays the golden tax eggs." Gluck, supra note 43, at 401.

\textsuperscript{56} Letter by Commissioner Caplin to Stanley S. Surrey, regarding the problems encountered by the IRS in dealing with T & E deductions, \textit{Hearings before the Committee on Finance of the United States Senate}, 87th Cong., 2d Sess. 280, 288 (1962).

\textsuperscript{57} \textit{Id.} at 273.


\textsuperscript{59} Silverman v. Commissioner, 253 F.2d 849 (8th Cir. 1958).
of dog food and boxes of tissue paper.\textsuperscript{60} Although many writers consistently advocated accurate recordkeeping through the use of expense account diaries, the idea was rejected as an impossible task, considering the hurried schedules of businessmen.\textsuperscript{61} Expenses were paid with pocket cash, notations made by "little mental reservation[s],"\textsuperscript{62} usually resulting in grossly exaggerated figures in the tax return.\textsuperscript{63} Attorneys faced the task of reconstructing or estimating T & E deductions on the basis of their client's estimate.\textsuperscript{64}

The Cohan rule seemed to offer the only solution, and approximations were allowed where it could be shown that some amount was legitimately spent.\textsuperscript{65} The rule, however, adapted itself more readily to the determination of the traveling expense deduction than it did to entertainment. The taxpayer's travel expenses could be reconstructed by computing the total number of days away from home, destinations of travel, and average cost of meals and lodging in the particular area. But in the entertainment field, the task was much more difficult, since there was no objective standard upon which determinations could be based.\textsuperscript{66}

As the situation evolved, revenue agents began to scrutinize the returns closely in their application of Cohan, tending to "bear heavily upon the taxpayer whose inexactitude was of his own making."\textsuperscript{67} The judgment of the agent often differed from that of the taxpayer, which in turn gave rise not only to "considerable controversies at the examining officer level, but [also] the charge that

\begin{footnotesize}
\textsuperscript{60} Hearings, supra note 56, at 280.

\textsuperscript{61} See Gluck, supra note 43, at 401; Business Expense Deduction—The Cohan Rule, 36 TAXES 177, 178 (1958); Stuart, Social Club Dues and Expenses, 31 TAXES 69, 71 (1953); Mintz, Executives Expense Accounts and Fringe Benefits: A Problem in Management, Morality, and Revenue, 1 J. TAXATION 2, 8 (1956); Perkins, Recommendations for Preventing Disallowance of Expenses for Travel and Entertainment, 4 J. TAXATION 10, 13 (1956).


\textsuperscript{63} "To illustrate: A taxpayer honestly believes that he has incurred deductible T & E expense of $500 during the taxable year. He has not, however, kept records to substantiate the deduction. Knowing of the Cohan rule and believing that the Internal Revenue Service will only allow a deduction for 50 percent of whatever amount he claims, he files a return claiming a deduction for T & E expense in the amount of $1000." Caplin, The Travel and Entertainment Expense Problem, 39 TAXES 947, 961 (1961).

\textsuperscript{64} Perkins, supra note 61, at 12.

\textsuperscript{65} See note 43, supra.

\textsuperscript{66} Caplin, supra note 63, at 959.

\textsuperscript{67} See Cohan v. Commissioner, 39 F.2d 540, 543 (1930).
\end{footnotesize}
the agent [was] questioning the taxpayer's integrity.\textsuperscript{68} The resulting friction between the IRS and the taxpayer was distasteful to both parties, and tended to create a "poor public image of the Service."\textsuperscript{69}

A more important consequence of the agent's closer scrutiny, however, mushroomed the problem to "unmanageable proportions."\textsuperscript{70} Realizing that the revenue agent would probably disallow a portion of their unsubstantiated T & E items, taxpayers began to deliberately overstate their deductions, in the hope of ending up with something that approached what they deemed the proper figure.\textsuperscript{71} For example, even though the taxpayer usually paid his T & E expenses by check, he would compound his deduction by adding large amounts for cash entertainment.\textsuperscript{72} Audits of returns became a matter of "negotiation and bargaining,"\textsuperscript{73} as more and more taxpayers boarded the accelerating bandwagon.\textsuperscript{74} Even those not fortunate enough to have an expense account were "motivated... to claim T & E expenses which they did not actually incur."\textsuperscript{75}

Moreover, competition among business firms forced companies to meet the entertainment custom of the industry or face lower profits. Businesses came to be judged not on the merits of their product, but on how lavishly they could entertain, "larger expenses indicating a more aggressive business."\textsuperscript{76}

In deciding whether a particular expenditure was to be classified as business or personal, courts considered the prevailing custom. If the expense was customary in the type of business involved, the deduction was usually allowed.\textsuperscript{77} This resulted in a considerable expansion of the "ordinary and necessary" test, and contributed substantially to snowballing sums of T & E deductions.

\textsuperscript{63} Hearings, \textit{supra} note 56, at 281.
\textsuperscript{69} Ibid.
\textsuperscript{71} Caplin, \textit{supra} note 63.
\textsuperscript{72} Hearings, \textit{supra} note 56, at 282.
\textsuperscript{74} Hearings, \textit{supra} note 56, at 282.
\textsuperscript{75} Id. at 287.
\textsuperscript{76} Lipoff, \textit{supra} note 73, at 190.
\textsuperscript{77} Lipoff, \textit{supra} note 73, at 188.
As restaurant business thrived and entertainment costs swelled, those who were left out of the "game" became cognizant of the problem, and, with mounting contempt, began to term the insiders the "expense account aristocracy." The ignominious "swindle-sheet" came to be both a public derision and a way of life for many taxpayers.

78 "In cities like New York, Washington, and Chicago, it is safe to say that at any given moment well over half of all the people in the best hotels, the best nightclubs, and the best restaurants are charging the bill as an expense account to their companies. . . ." Rothschild and Sobernheim, Expense Accounts for Executives, 67 YALE L. J. 1363, 1364 n.4(1958); "There are precious few Americans of private means who can or will patronize restaurants where the luncheon tab for the chef's suggestion can come to $45 for two, but such plush premises as the Four Seasons in New York are jammed to the reservation desks with expense account patrons paying $200 for dinner for five. . . ." Beebe, Expense Account Caviar, San Francisco Chronicle, March 20, 1961, p. 36.

79 "[T]he interaction of expense account habits and income tax rules distorts the price system and weakens the moral fibre of the country. The evidence offered includes such trends as the climbing prices of beef-steaks and theater tickets, the sea-going convention, and the recently disclosed business interest in ladies whose telephone numbers can be bought." Life at Uncle Sam's Expense, THE ECONOMIST, April 4, 1959, p. 234.

80 See Caplin, supra note 63, at 961.

81 "[J]ust about every kind of human activity in the nature of fun and frolic is being well subsidized on behalf of a privileged few by the average taxpayer who does not happen to be engaged in a trade or business so as to enable him to join in this Government supported highlife. Is it any wonder, then, that such strong taxpayer resentment . . . developed against the expense account privilege?" Supplemental and Minority Views of Senators Douglas and Gore, supra note 70, at 3930.

82 Lipoff, supra note 73, at 187.

83 Rothschild and Sobernheim, supra note 78, at 1388.

84 A chairman of the board of one of the country's largest steel companies vividly described the situation: "Gone are the days when a salesman occasionally wined and dined his favorite customer, or perhaps gave a small theatre party. Nowadays, when the deal gets big enough, the company yacht weighs anchor and moves into position, the company plane takes off for a duckblind in Arkansas, or the best hotel in Miami throws open its doors to expectant dealers for a week of continuous circus.

"The distaff side is cut in, too, on both sides of the deal. How the ladies love it! With jet travel what it is, those who were getting a little tired of White Sulphur may now hope to look in on Capri or the Riviera.

"The unseen partner in all this largesse, of course, the man who rides the afterdeck of the company yacht, copilots the duck hunter's plane, sits by while the caviar is spooned out and the crepes suzettes are sizzling, the man who splits the check at the nightspot and hands the
Noting the growing public resentment, the tax administrators began to fear the collapse of the self-assessment technique, which is the foundation of our taxing laws. President Kennedy termed the situation "a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well."

As a result, attention began to be focused upon elimination of the Cohan rule from the tax law structure. What originated as a compromising tool to aid the inefficient taxpayer who negligently failed to keep records, had become a device by which a myriad of taxpayers maintained a standard of living far beyond the means of their reported salaries. Efforts were begun to correct a thirty-two year old mistake and restore public confidence in the system of federal taxation.

V. THE SOLUTION

A. A NEW STATUTE

(1) Progression through Congress.

Recognizing the problem, Congress last year offered its solution. Under the original proposal of the President, the cost of business entertainment and the maintenance of entertainment facilities would have been disallowed as a tax deduction. Restrictions would have been imposed upon the deductibility of traveling expenses so that business trips could no longer be combined with vacations.

The House, however, rejected the idea of complete disallowance, and divided entertainment and related expenses into two categories—those for activities and those for facilities. A deduction

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bill to the headwaiter, is none other than Uncle Sam.” Randall, The Myth of the Magic Expense Account, Dun’s Review, August 1960, p. 39.

Lipoff, supra note 73, at 183. See also Boehm, Ordinary and Necessary Expenses: Proximate Relationship as a Rejuvenated Test for Deductibility, 30 U. Cin. L. Rev. 1, 2 (1961); Rothschild and Sobernheim, supra note 78, at 1392.


See note 56, supra, and accompanying text.

Revenue Act of 1962, § 4, 76 Stat. 960: “Disallowance of Certain Entertainment, Etc. Expenses.” The new statute also contained, in addition to the rules for the deductibility of travel and entertainment expenses, substantial limitations upon the deductibility of business gifts. Since this article is limited to travel and entertainment items, however, the "business gifts" provision of the statute will not be treated.

President’s Tax Message to Congress, supra note 86, at 6380.
for an entertainment activity could be obtained only when it was shown that the activity was "directly related to" the taxpayer's trade or business. Expenses for entertainment facilities could be deducted only when the facility was used "primarily for" the furtherance of the taxpayer's trade or business.\textsuperscript{90}

To insure at least a partial deduction for goodwill entertainment, the Senate amended the bill to read that an entertainment item would be deductible if it were either "directly related to or associated with" the active conduct of the taxpayer's trade or business.\textsuperscript{91} The new language was to guarantee the deductibility of goodwill entertainment "without regard to whether a particular exception applies . . . ."\textsuperscript{92}

But the Conference Committee was dissatisfied with the Senate's amendment to the House proposal. As a consequence, it qualified the Senate's "associated with" rule so that, under the law as it now appears, it relates only to items "directly preceding or following a substantial and bona fide business discussion. . . ."\textsuperscript{93}

(2) \textit{Statutory Requirements for Deductibility of T & E Items}

Instead of establishing additional positive tests for deductibility, the new statute was added to the "Items not Deductible" category of the 1954 Code as section 274.\textsuperscript{94} This section provides, in specific negative terms, when travel and entertainment expenses will be disallowed.

(a) \textit{Entertainment Expenses.}

As previously mentioned, the words "entertainment expenses" had heretofore not appeared in the Code, their deduction being based upon the concept of an "ordinary and necessary" business expense.\textsuperscript{95} In section 274, however, entertainment expenses are mentioned specifically, and include expenses for "entertainment,


\textsuperscript{91} Ibid.


\textsuperscript{93} See Grossman, \textit{supra} note 90, at 1052.

\textsuperscript{94} INT. REV. CODE OF 1954, § 274.

\textsuperscript{95} See note 8, \textit{supra}, and accompanying text.
amusement, or recreation."\textsuperscript{96} For a legislative definition of the concept, the Senate Report states:\textsuperscript{97}

Entertaining guests at night clubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation and similar trips are examples of activities that constitute "entertainment, amusement, and recreation." In addition, "entertainment" includes any business expense incurred in the furnishing of food and beverages, a hotel suite, a vacation cottage, or an automobile either to a customer (present or potential) or to any member of such a customer's family.

In determining whether a particular item shall be regarded as a legitimate entertainment expense, "an objective standard\textsuperscript{98} will be used. If the activity is generally of the type considered to constitute "entertainment, amusement, or recreation," it will be so treated for purposes of the statute. Arguments such as that "entertainment" means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations, will be thereby precluded.\textsuperscript{99}

(i) "Directly Related To" Test.

The statute provides that no deduction will be allowed for any entertainment "activity" unless the taxpayer establishes that it was "directly related to," or, in the case of an item directly preceding or following a substantial and bona fide business discussion, that it was "associated with," the active conduct of his enterprise.\textsuperscript{100}

To meet the "directly related" test, it must first be shown that the item was an ordinary and necessary expenditure within the meaning of section 162 or 212. Then, the taxpayer must prove that the predominant purpose of the outlay was to further his trade or

\textsuperscript{96}\textbf{\textit{INT. REV. CODE OF 1954, § 274 (a) (1) (A).}}

\textsuperscript{97}S. \textbf{\textit{REp. No. 1881, supra note 92, at 3546. Under the Proposed Treas. Reg. § 1.274-2(b), 28 Fed. Reg. 3138 (1963) the term “entertainment” includes any expenditure incurred “in satisfying personal, living, or family needs of any individual which is claimed as a business expense by the taxpayer. . . .” Expenditures relating solely to the taxpayer or his family fall within this definition. However, if the term would clearly not be regarded as constituting entertainment, it will not be considered as such. Examples of this last statement include supper money furnished by an employer to his employees working overtime, a hotel room maintained by an employer and furnished to an employee for lodging while traveling, or an automobile used in the active conduct of the trade or business even though used incidentally for commuting to and from work.}}

\textsuperscript{98}\textit{Ibid.}

\textsuperscript{99}\textit{Ibid.}

\textsuperscript{100}\textbf{\textit{INT. REV. CODE OF 1954, § 274(a).}}}
business. In this consideration, his own motive is irrelevant, and it makes no difference that he would not have done the entertaining except for the attendance of his business related guests.

Under the Service's Proposed Regulations explaining this "directly related" test, the item is deductible if it is established that it was an expenditure for entertainment occurring in a clear business setting, wherein the person entertained would have reasonably known that the taxpayer's only motive was to further business. The item will also be considered as directly related to the active conduct of the taxpayer's business if it is established that it was incurred directly or indirectly for the benefit of an individual (other than an employee) as compensation for services rendered, or was paid as a prize or award which is required to be included in gross income under section 74. The example given is of a company which provides a vacation trip for retailers of its product who exceed sales quotas, and the trip is treated as compensation for services rendered. In addition, where the expenditure is for fees paid to a club used by the taxpayer primarily for the furnishing of food and beverages to customers or associates under circumstances conducive to a business discussion, the item will also be considered as having met the "directly related" test.

In all other situations, however, the item will be considered as directly related to the active conduct of the taxpayer's business only if it meets four specific requirements: (a) First, it must be

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101 S. Rep. No. 1881, supra note 92, at 3546. "To justify their deduction, a taxpayer must establish that the incurring of the expenses relating to the entertainment activities was directly related to . . . his effort to obtain new business or to encourage the continuation of an existing business relationship. This means that he must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law."

102 Proposed Treas. Reg. §§ 1.274-1 to -4, -6, -7, 28 Fed. Reg. 3138 (1963), defining and elaborating upon the various tests for deductibility (as contrasted with the substantiation regulations, which already appear in finalized form), were issued on March 30, 1963.


shown that when the expenditure was made, the taxpayer had more than a general expectation of deriving income at some indefinite future time. He must show that he would not have incurred the expenditure but for the fact that he had the expectation of deriving income or some other specific business benefit (excluding goodwill) immediately or at a definite or readily ascertainable future time. That income in fact resulted as a direct consequence of the expenditure need not be shown, however. (b) Next, he must prove that during the entertainment period he (or his representative) actually engaged in a bona fide business discussion, negotiation, or transaction for the purpose of obtaining income or other specific business benefit (excluding goodwill). (c) Third, he must prove that the principle character of the combined business and entertainment was the active conduct of his enterprise. (d) Finally, the expenditure must have been allocated to a person with whom the taxpayer engaged in the active conduct of his trade or business during the entertainment. If the taxpayer cannot meet any of the last three requirements, he must show that his intentions or expectations were thwarted by circumstances beyond his control.\footnote{Proposed Treas. Reg. § 1.274-2(c) (3), 28 Fed. Reg. 3139 (1963).}

On the other hand, the Proposed Regulations state that the expenditure will be considered as not directly related to the active conduct of the taxpayer's trade or business if the entertainment occurred under circumstances where the possibility of engaging in the active conduct of business was negligible. For example, if the taxpayer (or his representative) were not present, or if the distractions were substantial (such as at a night club or cocktail party, or on a yacht or fishing trip), the expenditure will be considered as not having met the "directly related" test unless the taxpayer clearly establishes to the contrary.\footnote{Proposed Treas. Reg. § 1.274-2(c) (7), 28 Fed. Reg. 3139 (1963).}

(ii) "Associated With" Test.

The "associated with" test governs entertainment of a particular type—that which immediately precedes or follows a "substantial and bona fide" business meeting or discussion.\footnote{Int. Rev. Code of 1954, § 274(a) (1) (B).} The statute expressly states that this phrase includes business meetings at conventions and other similar events.\footnote{Int. Rev. Code of 1954, § 274(a) (1) (A).} In such cases, the taxpayer need not establish that the entertainment was "directly related to" his trade or business, but only that it was "associated with" it.

\footnote{Proposed Treas. Reg. § 1.274-2(c) (3), 28 Fed. Reg. 3139 (1963).}
\footnote{Proposed Treas. Reg. § 1.274-2(c) (7), 28 Fed. Reg. 3139 (1963).}
\footnote{Int. Rev. Code of 1954, § 274(a) (1) (B).}
\footnote{Int. Rev. Code of 1954, § 274(a) (1) (A).}
Since this provision covers most goodwill entertainment\(^{111}\) (as contrasted with the "directly related" test), understanding it becomes quite important. As stated in the Conference Report:\(^{112}\)

> It is the understanding of the conferees ... that the ... "or associated with" test ... would permit a deduction for the cost of an entertainment item, even though the item is not directly related to the active conduct of the taxpayer's trade or business, if the item is associated with it, so long as the entertainment directly precedes or follows a substantial and bona fide business discussion.

Whether a particular business meeting qualifies as a "substantial and bona fide business discussion" depends on the facts and circumstances of each case. Although the discussion of business is not required,\(^{113}\) the taxpayer will probably be required to establish that he (or his representative) actively engaged in the meeting or transaction for the purpose of obtaining income or other specific business benefit (excluding goodwill) immediately or at a definite or readily ascertainable future time.\(^{114}\) Moreover, it must be shown that the principal character of the combined entertainment and business time spent together by the taxpayer and the persons entertained was the active conduct of business.\(^{115}\)

Under the Proposed Regulations, the entertainment generally will not be considered as having directly preceded or followed the business discussion unless it occurs the same day as the business meeting. However, if the taxpayer's guests come from out of town to engage in the business discussion, the entertainment of such persons the evening before or after the business discussion will be regarded as meeting the test.\(^{116}\)

Once the taxpayer establishes that the business meeting was "substantial and bona fide," he must then show that the entertainment connected with it was "associated with" the active conduct of his trade or business. This test will be met if the taxpayer establishes that the expenditure was ordinary and necessary, and that he had a clear business purpose in incurring it, such as to obtain new business or to encourage the continuation of an existing business

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\(^{111}\) "Such entertainment expenses ... will be deductible even though the purpose of the entertainment is merely to promote goodwill in [the taxpayer's] ... business." Conf. Rep. No. 2508, supra note 108, at 3950.

\(^{112}\) Id. at 3952.

\(^{113}\) Ibid.


\(^{115}\) Ibid.

relationship. Any part of the expenditure allocable to a person unconnected with those who engaged in the business discussion will not be considered as "associated with" the active conduct of the taxpayer's trade or business. However, the test does comprehend the spouse of the person who engaged in the business discussion.

In this area of goodwill entertainment, a major exception to the "directly related" and "associated with" prerequisites seems to confusingly overlap with the business meeting deduction. Section (e) of the statute provides that business meals furnished to "any individual under circumstances which are of a type generally considered to be conducive to a business discussion" are deductible expenses without regard to these tests. The Commissioner informs us:

"The environment must generally be conducive to the discussion of business. The predominant purpose of the meeting must be to further business. The distractions must not be substantial, and the number of persons entertained must not be large. The taxpayer must usually be present, and there must be a reasonable expectation of deriving some other economic benefit."

The Conference Report, however, seems to be speaking in broader terms:

"Under the business meal exception . . . the cost of providing food and beverages at most business meetings and banquets would be deductible, as well as almost all restaurant and most hotel entertaining . . . . [N]or under the business meal exception is there a requirement that business must actually be discussed in order to get a deduction."

The Proposed Regulations indicate that the exception extends to meeting customers in cocktail lounges or hotel dining rooms, as long as there are no distracting influences (such as floor shows), and as long as the meeting was not merely for social or personal purposes.

This exception, then, seems closely related to the "goodwill" form of entertainment which immediately precedes or follows a business meeting or discussion. In the business meal exception, the predominant purpose of the entertainment must be to further busi-

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119 INT. REV. CODE OF 1954, § 274(e) (1). See note 134, infra, and accompanying text.
121 CONF. REP. No. 2508, supra note 103, at 3952.
ness in some way, in surroundings which would, if required, be conducive to business discussion. In the “substantial and bona fide business discussion” case, the only requirement is that the entertainment immediately precede or follow the meeting, and that it be sufficiently “associated with” it. Most taxpayers should not find it difficult to fit most of their entertainment activities into one of these two categories. If they cannot, the “directly related” test will determine the allowance of the deduction.

(iii) “Primarily For” Test.

To obtain a deduction for the cost of maintaining an entertainment facility, the taxpayer must be able to show that it was used “primarily for” the furtherance of his trade or business.\footnote{123 INT. REV. CODE OF 1954, § 274(a) (1) (B).} In defining an entertainment facility, the Senate Report included:\footnote{124 S. Rep. No. 1881, supra note 92, at 3549.} Any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, home in vacation resort, dining room, and cafeteria. Dues to social, athletic, or sporting clubs are also treated as costs of maintaining an entertainment facility.\footnote{125 INT. REV. CODE OF 1954, § 274(a) (2) (A). See also Proposed Treas. Reg. § 1.274-2(e) (3) (ii), 28 Fed. Reg. 3140 (1963). Clubs used solely for business lunches are not considered social clubs. Ibid.}

In order to meet the “primarily for” test, the taxpayer must be able to show that the facility was used for business purposes more than 50% of the time, or the entire deduction is disallowed.\footnote{126 S. Rep. No. 1881, supra note 92, at 3687.} In this computation, it is the actual use of the facility which governs, and not its availability for use or the taxpayer’s principle purpose in acquiring it. If such use exceeds 50%, the deduction is only for the percentage “directly related to the active conduct of” the taxpayer’s business, rather than for the entire amount.\footnote{127 “For example, if the taxpayer acquires a fishing camp, which he uses almost exclusively for entertaining business guests, deductions of the expenses of the camp will be disallowed only to the extent that it was for personal or other non-business purposes.” Id. at 3550.}

For example, if the taxpayer establishes that he uses a yacht or club 75% for business purposes, his deduction is limited to 75% of its maintenance costs. If his business use is only 49%, however, he is entitled to no deduction at all.

Under the Proposed Regulations, any use of the facility for ordinary and necessary business purposes during one day will be
considered "one day of business use," even though the facility was also used during the same day for personal or family purposes. The same is true if the facility was used during one day for a "substantial and bona fide business discussion."128

An important distinction exists between the cost of maintaining the facility and the cost of entertaining at the facility. In the former case, the deductibility is governed by the "primarily for" test, and the amount of use "directly attributable to the active conduct of" the taxpayer's trade or business, whereas the latter is controlled by the rules pertaining to entertainment activities, such as the "directly related to," or, in the case of a business discussion, the "associated with" tests. Hence, expenditures for entertainment at the facility will be deductible as business expenses where the required business relationship is shown to exist between the taxpayer's business and the particular entertainment (provided, of course, the appropriate records are kept). The costs of maintaining the facility are deductible when the "over 50%" requirement is met, and then only to the extent of the amount attributable to business entertainment.129

(b) Traveling Expenses.

The statute provides that no deduction shall be allowed under either section 162 or 212 for that portion of traveling expenses which is not allocable to the taxpayer's trade or business.130 This provision was intended to abolish the "but for" rule existing in prior law. Notwithstanding that a substantial portion of the time spent was devoted to personal ends, the taxpayer could deduct the entire cost of the trip so long as he could establish that the trip itself would not have been made "but for" the business purpose involved.131 An exception was inserted into the act, however, so that the allocation rule pertaining to traveling expenses is not to apply when the travel away from home does not exceed one week,

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129 Deductions for the cost of maintaining a facility include depreciation and operating costs, such as rent and utility charges (for example, water or electricity), expenses for maintenance, preservation, repairs, painting, insurance, salaries for caretakers and watchmen, and losses realized on the sale or other disposition of the facility. See Proposed Treas. Reg. § 1.274-2(e) (3) (i), 28 Fed. Reg. 3140 (1963).
130 INT. REV. CODE OF 1954, § 274(c).
131 "This amendment will eliminate abuses whereby taxpayers often arranged vacations to coincide with a business trip so that they thereby, in effect, obtain a deduction for the vacation travel." S. REP. No. 1881, supra note 92, at 3553.
or where the portion of the time spent away from home not attributable to the taxpayer's trade or business or for the production of income is less than 25% of the total time spent on the trip.\textsuperscript{132}

(c) \textit{Exceptions.}

The statute contains nine exceptions to the "directly related" or "associated with" tests controlling the deductibility of entertainment expenses. For the items enumerated in these exceptions to be allowable as business expenses, they need meet only the "ordinary and necessary" test of prior law, or be expenses incurred for the production of income. Nevertheless, they remain subject to the substantiation requirements of the act as a prerequisite to deductibility.\textsuperscript{133}

The first exception has already been noted with respect to goodwill entertainment. This "business meal" exception provides that expenses for food and beverages which are furnished to any individual are deductible when furnished in surroundings conducive to business discussions. In determining the applicability of the exception, factors to be considered include the environment in which the meal or beverage was furnished, the taxpayer's trade or business (since some connection must be established), and the relationship to the trade or business of the person entertained.\textsuperscript{134}

Second, where food and beverages are furnished on the business premises of the taxpayer solely for his employees, the "directly related" or "associated with" tests do not apply. This exception is included in order to allow continued deductions for such facilities as a company cafeteria or an executive's dining room even though outside guests are occasionally served therein.\textsuperscript{135}

Next are excepted the expenses for goods, services, and facilities to the extent that such expenses are treated as compensation on the taxpayer's income tax return and similarly treated as wages for withholding purposes. The example given is of the taxpayer who permits an employee to use the company yacht for a vacation, and treats the expenses for its use as compensation to the employee.\textsuperscript{136}

\begin{footnotes}
\textsuperscript{132} INT. REV. CODE OF 1954, § 274(c).
\textsuperscript{133} S. REP. No. 1881, \textit{supra} note 92 at 3554.
\textsuperscript{134} INT. REV. CODE OF 1954, § 274(e) (1); S. REP. No. 1881, \textit{supra} note 92, at 3554-55.
\textsuperscript{135} INT. REV. CODE OF 1954, § 274(e) (2); S. REP. No. 1881, \textit{supra} note 92, at 3555.
\textsuperscript{136} INT. REV. CODE OF 1954, § 274(e) (3); S. REP. No. 1881, \textit{supra} note 92, at 3555.
\end{footnotes}
Fourth, the statute exempts expenses paid or incurred by the taxpayer for his employer or for a client under a reimbursement arrangement with such person. The purpose of this exception is to "prevent double disallowance of a single expenditure, once to the employee, or practitioner, and a second time to the employer or client." The exception does not apply, though, where the taxpayer is actually an employee and the employer treats the amount paid to him as compensation. Nor will the exception apply to the case of an independent contractor or practitioner unless he accounts to the person for whom the services are rendered sufficiently to enable such person to substantiate the same expenses under the records and receipts requirements of the statute. Where the exception is inapplicable, the taxpayer is thrown back upon the "directly related" or "associated with" tests.

An exception also arises where the employer incurs expenses for recreation or social activities primarily for the benefit of his employees. This provision specifically includes "fringe-benefit" programs. "Employees," on the other hand, does not include officers or shareholders owning more than 10% of the stock of the company, or "other highly compensated" members of the firm.

Sixth, the statute exempts expenses of stockholder's, agent's, and director's meetings, where such meetings are held for business, and not social, purposes.

The next exception pertains to expenses directly related to business meetings or organizations such as trade associations, chambers of commerce, real estate boards, and other business leagues.

By "items available to the public" the statute excepts the expenses for the entertainment of the general public through such media as television, radio, and newspapers.

The final exemption from the "directly related" or "associated with" tests is that of "expenses for goods or services ... which are sold by the taxpayer in a bona fide transaction for an adequate ... consideration in money or money's worth."145 The Senate Report indicates that this provision applies where the taxpayer sells entertainment to the general public. The salaries paid by him to performers (for example, in nightclubs, to performers) continue to be deductible expenses of his business operations. Furthermore, since these expenses are not really "entertainment" expenses of the taxpayer at all, the substantiation provisions of the statute do not apply.146

(3) Amendment of an Old Section.

Finally, perhaps as final insurance against future abuses, Congress amended section 162 by inserting the idea that "lavish or extravagant" expenditures will no longer be subsidized by the government. After amendment, section 162 reads:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

B. New Regulations.

To insure compliance with its new travel and entertainment rules, Congress added the requirement that all such expenses be substantiated. The statute, however, gave only superficial treatment to the substantiation requirement, leaving the detailed rules to the IRS. Consequently, section 274 provides only that the taxpayer must substantiate the amount, time, place, and business purpose of his deduction, together with the business relationship of persons entertained.148

The IRS immediately issued proposed regulations to supplement the mandate of Congress.149 In general, the proposed regulations carried the same theme as the final set; substantiate or face disallowance. In several areas, however, the stricter provisions of

147 Int. Rev. Code of 1954, § 162(a) (2).
the proposed regulations were superseded by more lenient rules in the final substantiation regulations. The Service's psychology was apparently to bear down heavily upon the taxpayer at first, thereby providing room for retreat when the protests surged. For example, the minimum amount at which a taxpayer is required to obtain a receipt for his expenditure was changed from $10 in the proposed regulations to $25 in the final regulations.

The substantiation rules were promulgated first to enable businessmen to promptly set up the required record-keeping procedures, in order that any deduction claimed at the end of the year may be adequately supported. Proposed regulations were recently issued to clarify areas left unanswered by the initial set, such as the "directly related" and "primarily for" tests. (1) Substantiation by "Adequate Records."

(a) Diaries and Receipts—"At or Near."

The fundamental requirement of the substantiation regulations is proof of each element of travel or entertainment expenditures by "adequate records." To meet this requirement, the taxpayer must maintain an "account book, diary, statement of expense or similar record . . . which [is] sufficient to establish each element of an expenditure. . . ." In addition to the account book or dairy, the taxpayer faces two situations in which he must maintain documentary evidence, such as receipts or paid bills, to support the deduction: (a) For any expenditures for lodging while traveling

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150 "Caplin has proposed regulations that all T & E deductions be itemized if they amount to more than $25. At first he put the figure at $10, knowing that it was unreasonably low, so as to give himself room for strategic retreat when the protests boiled forth, . . .." Taxes, Time, Feb. 1, 1963, p. 12, 15.


152 Treas. Reg. § 1.274-5(c) (2) (iii) (b) (1962).

153 For the 31 day period of January 1 through January 31, revenue agents have been instructed to allow "reasonable tolerances" in applying the statute and regulations. This was the "familiarization" period given to those taxpayers "who make good-faith effort to comply with the new rules as rapidly as possible." Furthermore, businessmen who employ mechanical accounting record-keeping techniques were given until March 31 to conform their systems to the new rules. T.I.R. 436, December 27, 1962.


155 Treas. Reg. § 1.274-5(c) (2) (1962).

156 Treas. Reg. § 1.274-5(c) (2) (i) (1962).
away from home; (b) For any other expenditure of $25 or more, except for transportation charges, in which case documentary evidence is required only if it is “readily available.”[167]

To be sufficient, the receipt must show several factors relating to the expense, including the “amount, date, place, and essential character” of the transaction.[158] A cancelled check made payable to a specific payee will not of itself be an adequate receipt, but the same check together with a bill from the payee is sufficient to establish the single element of the amount.[159] The IRS provides us with two examples of what must be shown in a receipt:[160]

[A] hotel receipt is sufficient to support expenditures for business travel if it shows the hotel name and location, the date, and separate amounts for charges such as lodging, meals, and telephone. A restaurant receipt would be sufficient if it shows the name and location of the restaurant, the date, and the amount of the expenditure (and if a charge is made for an item other than meals and beverages, such as a tip, an indication that such is the case).

Receipts, as well as account books, must be retained by the taxpayer as long as his tax return is open for audit. This normally is three years from the date he files his return, unless fraud is involved, in which case there is no statute of limitations.[161] While these records are not required to be submitted with the return, the taxpayer must state therein, probably in answer to a question,[162] whether he has the necessary substantiation. If he does not, the deductions will be automatically disallowed by the IRS. If he does, the taxpayer must keep his receipts for three years, as stated above, and be subject to the possibility of being called in by the Service to support his deductions. If an audit of his return reveals that he has no records or receipts, the taxpayer will be subject to either a negligence, fraud, or perjury penalty, as the situation warrants.[163]

The regulations further explain that the entry in the diary or account book must be made “at or near the time of the expenditure,”[164] while the details are still fresh in the taxpayer’s mind, and

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158 Treas. Reg. § 1.274-5(c) (2) (iii) (1962).
160 Id. at 12.
161 Id. at 13.
163 Ibid.
when he has "full present knowledge of each element of the expenditure." The IRS reasons that:

A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall.

(b) Other Methods of Substantiation.

Where there are no records or documentary evidence, the deduction will generally be disallowed. But, the regulations do provide that substantiation may be accomplished by "other sufficient evidence," consisting of the taxpayer's own statement in writing containing the specific information in detail as to each element of the expenditure, together with other corroborative evidence. Direct corroborative evidence, such as a written statement or oral testimony of witnesses, is required to substantiate the cost, time, or place of the item. If the element to be proved is either the business purpose or the business relationship, the corroborative evidence may be circumstantial.

Special provisions govern if the failure to produce the adequate records is due to circumstances beyond the taxpayer's control, such as fire, flood, earthquake, or other casualty. In such case, the taxpayer has the right to reconstruct his expenditures as a basis for allowance of the deduction.

(c) Separate Expenditures v. Aggregation.

The regulations provide that each separate expenditure must be recorded separately in the account book or diary, and a separate receipt obtained therefor. Each separate payment is considered a separate expenditure, but "concurrent or repetitious expenses of a similar nature occurring during the course of a single event shall be considered a single expenditure."

The taxpayer is allowed, at his option, however, to aggregate certain amounts, even though they would each be considered sep-

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165 Treas. Reg. § 1.274-5(c) (2) (ii) (a) (1962).
172 Treas. Reg. § 1.274-5(c) (6) (i) (b) (1962).
arate expenditures.\textsuperscript{173} Such items include amounts expended for meals while traveling, and expenditures for taxi-fares, telephone calls, gasoline and oil, parking fees, and tips, to be aggregated on a one-day basis in their respective categories.\textsuperscript{174} Furthermore, tips may be aggregated with the cost of the underlying expense—for instance, with the price of the dinner for which the tip is given. It should be remembered, though, that the tip remains a separate expenditure in determining whether a receipt should be obtained. Thus, a $24.00 dinner and a $4.00 tip may be recorded by a single entry in the diary (e.g.: “Dinner and Tip—$28.00”), but a receipt need not be obtained for the occasion since neither separate expenditure has exceeded $25.\textsuperscript{175}

(2) Elements of Substantiation.

(a) Travel and Entertainment Activities.

As previously stated, the “accurate records” requirement of substantiation involves maintaining a diary or account book listing each element of the expense. For traveling expenses, as distinguished from transportation expenses (which do not include meals and lodging),\textsuperscript{176} the diary must show the following four elements:\textsuperscript{177}

1. The cost of the transportation, meals and lodging, plus all other incidental costs such as telephone, telegraph, and sample rooms. (These incidental costs may be aggregated as noted above.)
2. The dates of departure and return for each trip, and the total number of days away from home on business.
3. The names of the destinations or places of travel.
4. The business purpose or purposes of the trip and the nature of the business benefit to be derived therefrom.

Substantiation for entertainment expenditures is more complex, involving a breakdown for different types of expenditures. In gen-

\textsuperscript{173} Treas. Reg. § 1.274-5(c) (6) (i) (b) (1962).
\textsuperscript{174} Ibid. See also CCH, How to Handle Expense Accounts in 1963, Dec. 1962, p. 11.
\textsuperscript{175} IRS, Questions and Answers Regarding Substantiation of Travel, Entertainment, and Gift Expenses, Dec. 28, 1962, p. 19.
\textsuperscript{176} For an excellent analysis of the traveling expense deduction, the definition of the word “home” under the tax laws, and the “overnight” requirement, see Haddleton, Traveling Expenses “Away from Home,” 17 Tax L. Rev. 261 (1962).
\textsuperscript{177} Treas. Reg. § 1.274(b) (2) (1962).
eral, with regard to an expenditure for either an entertainment activity or facility, the taxpayer must record: 178

a. The cost of each separate expenditure for entertainment (subject to the aggregation of incidental costs, as noted above).

b. The date of the entertainment.

c. The place of the entertainment and the description of the type of entertainment provided, if such information is not otherwise apparent from the designation of the place.

d. The business purpose of the entertainment, or the nature of the business benefit expected to be derived therefrom.

e. The business relationship of the persons entertained. (This refers to the occupation or name, title, or other designation of the person entertained, which together must establish a business relationship to the taxpayer sufficient to warrant the deduction).

The insertion of an additional element to be substantiated indicates the interest of Congress and the IRS in establishing a solid business connection before an entertainment expense will be allowed.

An interesting qualification to the entertainment substantiation rules arises when the number of persons entertained is considerably large, and all are members of the same group or class. In such case, the taxpayer does not face the burdensome task of recording the name of each person in his expense record. Instead, he may make an entry indicating the type of entertainment and identifying the class to which all the persons entertained belong. "For example, where the taxpayer entertains all of the stockholders of a small corporation, a designation in his diary or account book of ‘all the stockholders of X Corporation’ would be sufficient." 179

When the entertainment is of the type which precedes or follows a “substantial and bona fide business discussion,” more elements are required to be recorded in the diary, in addition to those listed above for general entertainment. These include: 180

a. The date and duration of the business discussion.

b. The place of the business discussion.

c. The nature of the business discussion, plus the business reason for the entertainment, or the business benefit expected to be derived therefrom.

178 Treas. Reg. § 1.274(b) (3) (1962).


d. The identification of those persons entertained who also participated in the business discussion.

Where the records and receipts are accumulated by a company bookkeeper, and an executive desires not to reveal the subject of his entertainment activity, special provisions govern recordation of the above elements. For example, if the president or other officer of a firm engages in a business meeting to consider such subjects as merger, consolidation, or trade secrets, the regulations provide that the business purpose, business relationship, names of conferees, or any other confidential information, need not be set out in the regular statement of expense. The information must be recorded, nonetheless, on some other statement "at or near the time of the expenditure," so that it will be available to the IRS if required.181

(b) Entertainment Facilities.

In regard to an entertainment facility, the taxpayer must record other information, again in addition to the five basic elements listed above which must be recorded each time the facility is used for business entertaining.

Since the facility must be shown to have been used "primarily for" the taxpayer's trade or business before any deduction may be taken, each use of the facility must be recorded separately. When the use is not related to his business, a diary entry such as "personal use" or "family use" is sufficient. But when the use is for business purposes the five elements to be recorded for general entertaining must be noted. The separate notations for each use are then consulted at the end of the period to determine whether the over-50% requirement has been met.182

To deduct the prorated costs of maintaining the facility, the taxpayer must show them in his records, under such classifications as club dues, mileage, or its equivalent (in cases of yachts or airplanes), depreciation, and losses realized on sales of such facilities.183 If the taxpayer fails to keep adequate records of the use of a facility, and it is of the type likely to serve personal uses, the presumption is that such use was primarily personal, and the costs of maintenance will not be allowed as a deduction.184

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181 Treas. Reg. § 1.274-5(c) (2) (ii) (c) (1962).
183 CCH, supra note 174, p. 29.
(3) Employees Under Per Diem or Mileage Allowances.

The regulations contained no specific rules for substantiation where an employee operated under a per diem, mileage, or similar allowance from his employer, but the Commissioner was to have the authority to issue such rules at a later date. Actually, however, these rules were issued the same day as the final regulations, in an IRS Technical Release. The release provides that an employee’s expenses for travel away from home, where the employer reimburses him in an amount not exceeding $25 per day, or provides him with a similar per diem allowance, or where the employee receives a mileage allowance not exceeding 15¢ per mile, will be regarded as substantiated. Two requirements must be met, however, before this rule will operate: (1) the employer must reasonably limit payment to ordinary and necessary travel expenses; and (2) the elements of time, place, and business purpose of the travel must be proved by adequate records and sufficient documentary evidence. An employee operating under such an allowance, therefore, need not substantiate the amounts expended while away from home, but need only offer proof for the elements of time, place, and business purpose.

On the other hand, if the “employee” doing the traveling owns more than 10% of the stock in the corporate-employer, the rule does not operate, and the general rules for substantiating traveling expenses control. The same is true if the per diem allowance exceeds $25 per day, or the mileage allowance exceeds 15¢ per mile. In these cases, the element of cost must be substantiated for each separate expenditure.

(4) Employees Making an Adequate Accounting to Employer.

The regulations further break down the substantiation by differentiating between certain types of employees. In providing the substantiation rules for travel and entertainment expenses of employees, the rules are phrased in terms of two groups: (1) those employees who are required to, and do, make an adequate accounting to their employer; and (2) those who do not.

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187 Ibid. See also IRS, QUESTIONS AND ANSWERS REGARDING SUBSTANTIATION OF TRAVEL, ENTERTAINMENT, AND GIFT EXPENSES, Dec. 28, 1962, p. 15.
188 Ibid.
(a) Definition and Consequences of Adequate Accounting to Employer.

An "adequate accounting to the employer" is defined as the submittal to the employer of the employee's account book or diary, together with the necessary documentary evidence. The employee must also account for all amounts received from the employer as advances or reimbursements for T & E expenses, including those amounts charged against the employer either directly or indirectly, as through the use of credit cards.

An employee who has made an adequate accounting to his employer will not ordinarily be called upon later to substantiate such items for the IRS. There are three exceptions to this statement: (1) where he is related to his employer within the meaning of section 267(b) or owns more than 10% of the stock in the corporate-employer; (2) where the employer's accounting and record-keeping procedures are found to be inadequate; and (3) where his business expenses for travel or entertainment exceed the total of reimbursements or advances received from the employer, and the employee seeks to take a deduction for the difference on his return.

(i) Reimbursements Less Than Expenses Paid or Incurred.

To obtain a deduction for the amount of his expenses which exceeded his reimbursements, an employee must submit certain information with his return in addition to the substantiation otherwise required for each element of his expense. Such additional information must further explain the deduction in terms of:

a. The total reimbursements received from the employer, including amounts charged against the employer directly or indirectly;

b. The description of his occupation;

c. The total number of days away from home on the business of the employer;

d. The total business expenses paid or incurred by the employee, again including those charged directly or indirectly against the employer. These expenses must be broken down into the usual categories of traveling expenses, such as transportation, meals and

191 Ibid. See also CCH, supra note 174, at 16, 18.
lodging, entertainment, and incidental costs. His records must show
the elements required for each separate expenditure of travel or
entertainment, and he must be able to produce the appropriate
receipts.

(ii) Reimbursements Exceeding or Equal to Expenses.

Where the employee does make an adequate accounting to his
employer, and his reimbursements are equal to his expenses for
travel and entertainment, the employee need not report such items
on his return. Where the reimbursements received from the em-
ployer exceed his actual expenses, however, the employee must
then include the excess reimbursements in his income. The same
is true where he receives reimbursements for non-deductible ex-
penditures.

(b) Where No Adequate Accounting is Made.

Where the employee does not make an adequate accounting to
his employer (either because he is not required to or because he
fails to do so), the employee must attach a statement to his return
indicating the same information as the employee who claims a de-
duction for the amount of his expenses over reimbursements. This
is true whether the expenses of the employee are more than, less
than, or equal to, his reimbursements. Of course, adequate records
supporting each element of the travel or entertainment expense, and
receipts for all lodging expenses and other expenditures of $25
or more, must also be maintained.

Where the employer directly pays the expense, such as by pur-
chasing a train ticket for the employee, the latter need not record
the amount of the payment in his account book. But if the item
is charged against the employer indirectly by the employee the
latter must then make a record of the expenditure.

(5) Independent Contractors.

In attorney-client relationships, the attorney (an "independent
contractor") within the meaning of the regulations) has the bur-

197 IRS, QUESTIONS AND ANSWERS REGARDING SUBSTANTIATION OF TRAVEL,
198 Ibid.
199 "... travel, entertainment, and gifts paid or incurred by one person
(hereinafter termed "independent contractor") in connection with serv-
ices performed for another person other than an employer (hereinafter
den of keeping the records and receipts, both for himself and for his client. If the attorney incurs travel and entertainment expenses on behalf of his client, he may deduct such items, provided the expenditure meets the "directly related" or the "associated with" test, and provided he keeps the proper records establishing each element of the expense, along with the appropriate receipts. In the questionable cases, such as goodwill entertaining for his client, the attorney may obtain the deduction for his expenditures if he adequately accounts to his client by furnishing him with the records and receipts. The deduction is limited, of course, to the extent that the attorney is not reimbursed.

Where he has reimbursed the attorney, the client may obtain a deduction for the reimbursement so long as the attorney maintains the adequate records. The client does not have to obtain such records from the attorney in order to deduct the expenditure, unless the attorney in fact accounts to him, in which case substantiation will have to be made by the client in order to prove the deduction.

VI. ANALYSIS

A. EFFECT ON PRIOR LAW

(1) Cohan Rule Abolished.

It is obvious that in enacting the new rules both Congress and the IRS blamed Cohan for development of the widespread abuses which necessitated legislative action. The Senate Report reveals that the statute's substantiation requirements were intended specifically to overrule the Cohan case, and the regulations expressly state that the limitations contained therein supersede "with respect to any such expenditure the doctrine of Cohan v. Commissioner. . . ." Approximations, therefore, are no longer acceptable, and without the proper records and receipts, the taxpayer yields his entire claim.

(2) In Addition to Other Prior Tests.

Aside from the Cohan doctrine, the new rules are in addition to, and not in substitution for, the tests existing under prior law. Deductibility of T & E items now involves at least two separate, and somewhat complicated, steps. First, the taxpayer must show,

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200 Treas. Reg. § 1.274-5 (g) (2) (1962).
201 Treas. Reg. § 1.274-5 (g) (4) (1962).
as he presumably always has shown, that the travel or entertain-
ment item was an "ordinary and necessary" business expense,205
that it was incurred in the production of income,206 or that a travel-
ing expense was incurred while "away from home in the pursuit of
a 'trade' or business."207 Secondly, the taxpayer must allocate his
expenses between business and personal items, and with respect
to an entertainment activity, must show that it was "directly re-
lated to,"208 or in the case of a business discussion, that it was
"associated with,"209 the active conduct of his trade or business.
He must establish that an entertainment facility was used "pri-
marily for" business purposes.210 And he must be able to sub-
stantiate each element of each expense with the proper records
and receipts. 211 Moreover, since the purpose of the new rules is
to disallow deductions where the proper business relationship is
not shown or where they are not substantiated, they do not make
deductible any expense which was previously not allowable.212

(3) The Sutter Case.

The Sutter decision,213 holding that the cost of meals or other
entertainment for the taxpayer and his dependents is a non-deduct-
able personal expense, appears to remain unaffected by the new
statute and regulations. Consequently, even though the taxpayer
meets the "ordinary and necessary" and "directly related" tests
with respect to an entertainment expenditure, and is able to fully
substantiate each element, he must subtract the cost attributable
to himself and his family before claiming the deduction.

B. The "lavish or extravagant" Test.

One of the most puzzling questions concerning the new rules
is the applicability of the "lavish or extravagant" test. The only
reference to the term in Section 274 is found in its closing words—
in the amendment to the "ordinary and necessary" traveling expense
deduction found in section 162 of the Code. The amendment strikes
out the phrase "(including the entire amount expended for meals

209 Ibid.
and lodging),”214 and inserts therefor the phrase “(including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances).”215 The question immediately arises as to whether the “lavish or extravagant” exclusion applies only to traveling expenses, or whether it extends also to expenditures for entertainment, since the new statute speaks only in terms of the former. Nowhere in section 274 does it provide that lavish or extravagant entertainment expenditures are to be disallowed. Furthermore, the Senate Report, in clear language, states: “The bill ... makes it clear that the deduction provided for traveling expenses by section 162 (a) (2) of present law is not to include expenses for meals and lodging which are lavish or extravagant under the circumstances.”216

In pondering the applicability of the “lavish or extravagant” test to entertainment expenses, one authority is of the opinion that “lavish or extravagant [entertainment] expenses would probably in most cases be disallowed as disproportionate to expected business benefit.”217 There is a stronger reason, however, for applying the test to the expenses of entertainment. Returning to the Senate Report, we find the statement:218

[N]o deduction will be allowable ... for any “entertainment, amusement, or recreation” expenses which under the circumstances in which they are incurred are lavish or extravagant. This will be so even where a direct business purpose is firmly established.

The example given is of a midwestern taxpayer who, in establishing a residence at Miami Beach, asserts that lavish entertainment is essential in obtaining business. “Under the bill no deduction would be allowed ... for any portion of the expenses incurred ... which are lavish or extravagant.”219

Moreover, the Senate Report carries the principle even further. Again we are told that taxpayers who keep luxurious entertainment facilities, such as subtropical islands or other resorts, face disallowance of part of the cost of maintenance:220

As in the case of [entertainment] activities ... no deduction will be permitted for lavish or extravagant expenses incurred with

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217 CCH, supra note 174, p. 29.
219 Id. at 3549.
220 Id. at 3551.
respect to facilities. This means that luxurious resort facilities
maintained for the purpose of entertaining will no longer be fully
deductible.

Assuming, then, that the "lavish or extravagant" test does
apply to entertainment facilities and activities, as well as to travel-
ing expenses as spelled out in the statute, one big problem remains:
What is a lavish or extravagant expenditure? Necessarily, this de-
termination will have to vary depending upon the type of entertain-
ment involved—a yacht cruise, an evening at a nightclub, or a day
at the company hunting lodge. One writer asserts that "some tax-
payer will [surely] contend that the more lavish and extravagant
the expenditure is, the more likely it is to accomplish the desired
business purpose."\textsuperscript{221}

Referring to the mystery as a "red herring" in the Senate Re-
port, two Senators recognized it at its inception.\textsuperscript{222} In contending
that the Finance Committee should have been more explicit in its
definition, the two Senators stated:\textsuperscript{223}

\begin{quote}
[N]o standards or guidelines are furnished. What is lavish or ex-
travagant under the circumstances? If the circumstances involve
a taxpayer accustomed to entertaining in an elaborate and expen-
sive style, can they be held to be "lavish" under the circumstances?
When does a yacht become an extravagant expenditure? When it
is 60 feet in length? 100 feet in length? Would these criteria vary
with the income (or expected income) of the taxpayer? Would a
resident of Miami Beach, Fla., be entitled to a bigger and more ex-
pensive yacht than a resident of Providence, R. I.? Would a beach
home with eight rooms be a lavish facility? What about one with
30 rooms? Would a corporate president be entitled to drink cham-
pagne whereas a vice-president could have only a whiskey high-
ball and a proprietor of a country grocery store only ordinary corn
liquor?
\end{quote}

The Internal Revenue Service also recognizes the problem. In
promising more regulations to clarify the subject, the Commissioner
believes that standards will have to be established for people in
different positions, in order to determine what is "lavish or ex-
travagant" under each set of circumstances.\textsuperscript{224}

\begin{footnotes}
\item[221] Grossman, The Impact of the Revenue Act of 1962 on Travel and Entertain-
\item[222] Supplemental and Minority Views of Senators Douglas and Gore, 87th
\item[223] Ibid.
\item[224] How Tough a Crackdown on Expense Accounts? U.S. News & World
\end{footnotes}
C. PUBLIC REACTION

(1) Businessmen and Firms.

Many businessmen believe that the effect of the new rules has been to disallow all T & E deductions, or, at least, that deductions are no longer worth the bother of accurate record-keeping. One writer commented that the prevailing attitude is that all goodwill entertaining has been eliminated. Nevertheless, such is not the case. The statute and regulations were aimed at preventing abuses of, not eliminating, the expense account. As Commissioner Caplin has pointed out:

[It is] important to recognize that Congress has not told anyone how to spend his money or how much to spend. People can travel and entertain as freely and lavishly as they want to. Congress is in no way trying to prescribe the taxpayer's way of life.

Congress [only] wants to end the abuses of expense-account living. And the new legislation is aimed at placing those who are trying to take advantage of our tax laws on a tax parity with the rest of the public, which has to finance its own entertainment without benefit of tax deductions.

The quiet business meal is still deductible, as goodwill entertainment, so long as it is not lavish or extravagant and the surroundings are conducive to business discussion. No discussion of business need even occur if the taxpayer can establish the propriety of the surroundings and a close relationship to his business, whether it be a goodwill meeting or otherwise. The requirement is, however, that he keep adequate records of the expenditure and receipts to support separate items of $25 or more.

As to the record keeping requirements, the IRS tells us that the new substantiation rules are supposedly "consistent with practices followed for many years by prudent businessmen and prudently managed corporations." Since most businesses already keep good records, it is believed that "the final regulations will curb excesses without unduly hampering legitimate and moderate business expenses."

From another standpoint, the government believes that businessmen and firms will welcome the new crackdown on T & E de-

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228 Id. at 5.
ductions. In the past, firms were forced to make large outlays for entertainment of their customers in order to meet the practices of competing companies. President Kennedy was confident that "business firms, now forced to emulate the expense account favors of their competitors, however unsound or uneconomical such practices may be, will welcome the removal of this pressure."229

A problem may arise, however, regarding entertainment facilities maintained by a large firm. Assuming that the facility is used occasionally for personal purposes, it will be impossible to determine whether the over 50% requirement has been met until all the data are in. Thus, information will have to be accumulated, records kept, and receipts obtained throughout the year, with the chance that the cost of maintenance will be disallowed as a deduction due to too many personal uses. With careful planning, however, this can probably be avoided.

(2) The Restaurant and Entertainment Industries.

Now that the new rules are in effect, the restaurant and entertainment industries protest of "empty tables in restaurants ... closed night clubs ... hotels running in the red ... thousands of workers made jobless."230 But whatever loss of business underlies these complaints can probably be attributed to the confusion surrounding the new rules. As one hotel manager states, "[I]t's more uncertainty than anything else at this point. People just don't know."231 As businessmen begin to realize that the new rules are likely to endure, and familiarize themselves with their provisions, the clamor can be expected to subside.

Ignoring the fact that many segments of the restaurant and entertainment industries have heretofore been parties to open perversion of the tax laws, there is yet another answer to their remonstrations. One prominent restaurant owner testified that a major portion of the recent problem was not the money being spent by businessmen in restaurants, but rather the money that was deducted but actually not spent. It was not uncommon for a busi-
man, dining on his company's expense account, to put down double
the size of the check, and take the remainder of the money for him-
self.233

On this point, the restaurants and other entertainment indus-
tries should herald the new rules. Businessmen are now required
to record the amount of their expense "at or near" the time it is
incurred, and when $25 or more, they must obtain a receipt. Fol-
lowing this reasoning, restaurants can look forward to their patrons
actually spending the whole amount they wish to claim as a deduc-
tion. Whether this will curtail business spending over the long
run remains to be seen, but the fact is that what is spent will go
into the restaurant owner's till, rather than into the businessman's
pocket.

D. CIRCUMVENTION OF THE RULES.

Undoubtedly, the new statute and regulations are a severe
 crackdown in the T & E area, and as a result, will force many tax-
payers to re-evaluate their record keeping standards. Whether tax-
payers will find methods by which to circumvent some of the
stringent requirements invites speculation. One possible formula
has already been foreseen by the Commissioner: 234

On country clubs, for example, . . . the employer [might] give
the employee additional compensation sufficient to permit him to
pay his extra tax on that money and pay his country club dues
with the net amount. The country club dues might run $500 and
the employer might give the employee $750 for the year, just as
additional compensation, permitting the employer to take the de-
duction for this compensation. The employee would then be free
to use the $750, after paying his taxes, either on country club
dues or for whatever else he wanted to use it. . . . Obviously, this
would be more expensive for the company, but it would solve some
of the record keeping problems.

VII. CONCLUSION

The new expense account rules, as enacted by Congress and
complemented by the IRS, represent the culmination of a long-
ought battle waged upon abuses of travel and entertainment de-
ductions. The result is significant in the area of corrective legisla-
tion and tax reform, designed specifically to close a wide gap in
our loophole-riddled tax laws.

Had taxpayers contented themselves with application of the
Cohan rule as a compromising tool where accurate record keeping

233 See Gehman, Expense Accounts, Cosmopolitan, Mar. 1957, p. 44.
presented undue hardships, the recent crackdown would hardly have been necessary. Instead, however, a certain segment of the public stretched Cohan to unwarranted lengths, using it not only to substantially reduce their tax liability through gross overstatement of expenses, but also as a method of maintaining a standard of living disproportionate to their actual incomes. The resulting contempt for the expense account deduction by the unfortunate majority not able to participate necessitated rehabilitation of the law and restoration of public confidence in the system.

Nor is this the last step which taxpayers can expect in this T & E area. More rules are needed, and are promised, to clarify remaining uncertainties such as the "lavish or extravagant" concept. The proposed regulations defining various areas such as the "directly related" and "associated with" tests should soon be made final. Ultimately, however, the statute and regulations should provide firm and effective guides for legitimate travel and entertainment deductions.

Bruce Graves '64