Southern Business Review

Volume 33 | Issue 2 Article 4

June 2008

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Travel and entertainment expenses for business have always been deductible. These expenses are considered an integral part of businesses maintaining client relationships and developing new potential clients. After all, business is about maintaining current clients and obtaining new ones. Therefore, the tax deductions for these expenses have been and now are permitted as legal business expense tax deductions.

The *Tax Reform Act of 1986*

It became apparent under the Jimmy Carter administration that some of these legal tax deductions were being abused. Consequently, Congress decided to change the tax law. At first Congress wanted to forbid any business from taking a deduction for any alcoholic drinks. But on second thought[1] Congress decided not to do this. In addition, Congress still thought that excessive deductions for alcoholic drinks should not be permitted nor should excessive entertainment expenses be permitted. For example; front row tickets to the Super Bowl or the World Series when paying scalper prices would not be an appropriate expense. So, Congress decided to exclude 50 percent of all entertainment and business meals expenses. Congress called this the "three martini" business lunch rule, a name that has stuck and can be found in basic tax textbooks and in various business articles.

Therefore, instead of limiting the definition of a tax deduction Congress decided to limit all meal and entertainment expenses to 50 percent of expenditures. Under the *Tax Reform Act of 1986*, a business can still allow clients or potential clients to have "three martinis" at lunch but the tax deduction would be limited to 50 percent. The actual law can be found in *The Internal Revenue Code* Section 274.

As to tax deductible entertainment expenses, the tax code does not differentiate between what entertainment is acceptable and what is not. If one takes a client or potential client to the symphony it should be deductible as an entertainment expense. If one goes to a baseball game, that too would be deductible. But what if one takes a client to a wrestling match? The answer is that the tax code does not judge the quality of entertainment. As long as it is a legal activity, it can be a tax deduction.

This article will discuss selected U.S. Tax Court cases involving travel, meal and entertainment expenses. Cases will be cited from court decisions and the actual IRS code. The cases cited may seem to be, and in many cases are,

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contradictive. Most cases selected for analysis have occurred since the “Tax Reform Act of 1986” but some older cases were selected to demonstrate the historically contentious nature of business expense deductions claimed by corporate and individual taxpayers.

It can be tempting for a corporation or business owner to claim unsubstantiated travel, meal and entertainment expenses as business expense deductions. The non-deductible portion of travel expenses, and meal and entertainment expenses subject to the 50 percent reduction rule represent a dollar for dollar reduction in the gross income, thereby reducing taxable income.

Throughout the research of applicable cases it, became apparent that when travel, meal and entertainment expenses were disallowed by the courts, it almost always involved a lack of proper substantiation on the part of the taxpayer, whether corporate or individual, under IRS Code, Section 274(d). This paper will present multiple cases demonstrating this fact. Although this is only a small sampling of cases available for study, it provides a good understanding of some of the pitfalls involved in claiming business expense deductions and substantiating business expenses.

This article will attempt to provide the reader with guidance on how each of the cases involving disallowed deductions could have been properly handled and reported by the taxpayer in order to avoid unnecessary penalties or assessments of additional tax liability.

Corporate Petitions

***Churchill Downs Inc., et al. v. Commissioner,* 2000.**[2]

Churchill Downs Inc., is a for profit corporation that puts on high profile sporting events such as the Kentucky Derby at Churchill Downs and the Breeder’s Cup horse race on a rotating basis. Churchill Downs Inc., maintained that expenses incurred in sponsoring invitation only gala events were ordinary and necessary expenses under *IRS Code Section 162* and fully deductible, because, owing to the fact that they are in the entertainment business, the expenses were part of the entertainment product itself.

The Tax Court had previously ruled against Churchill Downs, Inc., ruling that while the expenses were ordinary and necessary, they are limited by the 50 percent rule under criteria outlined in *IRS Code Section 274(n)(1). Section 274(n)(1)(b)* states,

> [t]he amount allowable as a deduction under this chapter for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such activity shall not exceed 50 percent of the amount of such expense or item which would (but for this paragraph) be allowable as a deduction under this chapter.

Churchill Downs Inc., argued that as an exception under Sections 274(e)(7)(8), the entertainment they offered was available to the general public and sold for valid consideration. The court ruled that since the events in question were invitation only events, and no evidence existed of a bona fide transaction where entertainment was provided for valid consideration, that they did not qualify for an exception.

The court upheld the previous decision limiting Churchill Downs Inc., to a 50 percent deduction under Section 274. Tax deficiencies of $51,872 and $20,658 for the 1994 and1995 tax years were upheld by the court.

Churchill Downs Inc., may have been more successful had they not argued for the exception on the basis that the entertainment expenses were made available to the general public. Since they provided no corroborating evidence for this assertion, arguably, it likely only served to weaken their case.

Rapid Electric Co, Inc., v. Commissioner, 1973.[3]

Rapid Electric Co. Inc., owned two subsidiaries, Rapid Puerto Rico and Rapid New York, both wholly owned by Joseph Viola, who held 100 percent of the corporation stock. Rapid Electric New York deducted travel and entertainment expenses paid to Joseph Viola under the Internal Revenue Code Section 162 as ordinary and necessary business expenses on its 1964, 1965, and 1966 tax returns resulting in a reduction in income for those tax years. The 50 percent rule was not in existence at the time. Joseph Viola did not recognize income from the reimbursements because he considered it a reimbursement of travel and entertainment expense that he incurred on behalf of the corporation.

The tax court, in its original opinion denied the expense deduction to the corporation and ruled that the payments to Joseph Viola were not bona fide business expenses; therefore the travel and entertainment payments were classified as dividend payments from current or accumulated earnings. The case summary states,

> Rapid New York had a taxable income of \$18,113.94, \$25,812.94, and \$48,658.72, respectively, during the years 1964 through 1966.

The payment amounts to Mr. Viola that were in question are expressed below and are taken directly from the record of the court case.

Payments from Court Case

Year	1964	1965	1966
Cash	\$3,060	\$800	\$2,300
Airlines-Puerto Rico	986	1,221	608
Hotels-Puerto Rico	1,462	869	691
Total	\$5,508	\$2,890	\$3,599

In the appeal Rapid Electric Company argued that the payments to Joseph Viola represented additional compensation and could be deducted as ordinary and necessary business expenses under Section 162. Joseph Viola similarly argued in the appeal that he should include the payments as additional compensation in his gross income for the years affected, but that the payments should not be declared constructive dividends.

The court upheld its original ruling. The business expense deduction was disallowed for Rapid Electric resulting in increases in income equal to those amounts and Mr. Viola was forced to recognized dividend income equal to the amount of payments received.

Mr. Viola could have avoided recognition of income from (dividend income) and Rapid Electric could have justified business expenses attributable to travel and entertainment had they documented the business reason for travel, dates, business associates being entertained, topics discussed, etc. Mr. Viola's failure to document resulted in an unnecessary double negative tax liability effect to both him and the corporation that could have been avoided through prudent record keeping. The fact that the corporation had significant current and accumulated earnings while never declaring a dividend raised additional suspicion about the payments and did not help their case. It is also probable that he failed to properly separate his personal travel and entertainment expenses from his business dealings.

BJR Corporation, v. Commissioner of Internal Revenue, 1976[4]

One aspect of this case involves improper reporting of travel and entertainment expenses as deductions on a corporate tax return. The corporate return in question is for Jefferson Sales and Distributors Inc. which only had one tax year that spanned over 1969 and 1970. The corporation was subsequently merged into BJR Corp. J. Marshall Brown owned 80 percent of Jefferson stock by the end of 1969 and was dominant in conducting corporate affairs according to the court record. At issue was the disallowance by the Tax Court of a list of 25 travel and expense deductions claimed totaling $13, 237 of which only two were substantiated. The Tax Court's original judgment was that 23 of the 25 claimed travel and entertainment expense deductions failed to meet the substantiation requirements outlined in IRS Code Section 274.

The facts stipulated in the case indicated that J. Marshall Brown was involved in several other business interests during the time period in question including insurance, real estate, and construction. [5] He did not keep records and therefore there was no indication as to which business interests he was serving and how much time was spent on each while incurring various travel and entertainment expenses. Testimony given in the original case was vague and did not corroborate the assertion that the travel and entertainment expenses were ordinary and necessary.[6]

The original judgment was upheld in this case on appeal. Poor record keeping was the major reason why the travel and entertainment expenses were disallowed. All it would have taken was a record book showing essential details of how much time and money was spent on each business interest as well as dates and business associates contacted in the course of conducting business corroborated by receipts. Mr. Brown obviously failed to separate his business interests for purposes of recording travel and entertainment expenses resulting in the disallowance of most of the claimed deductions. Jefferson's failure to file a

timely tax return and their insistence that one was filed when the IRS had no record of it did not help their case either. BJR was responsible for timely filing of the return since they acquired Jefferson in a merger before Jefferson's tax return was due.

Mediaworks, Inc., Petitioner v. Commissioner of Internal Revenue[7]

In this case, entertainment expenses related to a luxury yacht were claimed as ordinary and necessary business expenses in the corporation's tax returns for 1998 and 1999. Mediaworks was run by Michael Roach who was their sole shareholder. At issue in the original Tax Court case was whether the yacht, purchased by Mediaworks, was used for business and business entertainment purposes or for the pleasure of Michael Roach. The original court decision determined that the claimed deductions of yacht expenses as ordinary and necessary business expenses were without merit and that the corporation failed to provide substantiating evidence that the yacht was used for business related entertainment. The court determined tax deficiencies of $65,772 and $53,459, for tax years 1998 and 1999 respectively related to disallowance of the business and entertainment expense claims related to the yacht.[8] The court also originally assessed accuracy related penalties of $13,154.40 and $10,691.80, respectively.[9] The accuracy related penalties were assessed for failure to exercise due care in preparation of the tax returns and for disregard of applicable rules and regulations pertaining to Mediaworks' expense claims.

Mr. Roach was an avid sailor and regularly sailed the yacht in competitions on the west coast. Mr. Roach misled his CPA as to the use and purpose of the yacht and his CPA prepared his tax returns for 1998 and 1999 on the basis of the information provided to him by Mr. Roach. Mr. Roach never indicated to his CPA that he regularly sailed the yacht in competition or that he used it for other than business use.

Roach's property tax records indicate for 1998 and 1999 indicate that the boat was used for pleasure. Roach's own testimony and a record of board minutes also indicated that the boat was used for pleasure. The court states, "even if the petitioner did meet the requirements of section 162(a) as to those expenses, it would still not prevail. Under section 274(a)(1)(B), deductions which otherwise would be allowable for expenses paid with respect to a "facility" are not allowed when the facility is used in connection with an activity which is of a type generally considered to constitute entertainment, amusement, or recreation." The court further stated, "The slightest use of a facility in connection with an activity which is of a type generally considered to constitute entertainment, amusement, or recreation operates under the text of section 274(a)(1)(B) to disallow any deduction as to that facility."

The court upheld the previous ruling and disallowed all expense deductions related to the yacht and upheld imposition of accuracy related penalties. This was a rather feeble attempt at tax avoidance which teetered on the edge of tax evasion. Mr. Roach could have saved a lot of money in penalties and attorney's fees if he had just dealt honestly with his CPA with regard to the nature of the expenses. His total lack of corroborative evidence to support his assertions combined with documentary evidence contradictory to his assertions sealed his fate.

Individual Taxpayer Petitions

Michael E. Hentges et ux. v. Commissioner[10]

Michael Hentges was an insurance salesmen and financial planner who petitioned the court to reconsider the judgment placed against him and his

wife for unsubstantiated automobile usage, plane rental, meal, and entertainment expenses claimed on their 1992 joint tax return. They also appealed the accuracy related penalty imposed related to the same unsubstantiated expenses.

Mr. Hentges failed to produce any corroborating evidence showing the airplane rental had any business purpose, and to the contrary, receipts for the rental indicated that it was for pilot flight instruction fees. He claimed that the flight bag containing his FAA flight logs was stolen and that he had to reconstruct part of the flight log for 1992 from memory. He also failed keep any log detailing business use of the Mercedes automobile that he claimed was used exclusively for business purposes. Both the airplane and the automobile are listed property and as such, business expense deductions related to these items are subject to the same substantiation requirements as other deductible travel, meal and entertainment expenses according to a December 1985 amendment to Section 274(d).[11]

With respect to deductions allowable under Section 274, the taxpayer always bears the burden of proof in establishing that expenses were ordinary and necessary to the conduct of their business. Record keeping must take place around the same time that the event occurred. Reconstruction of records after the fact does not meet the strict substantiation requirements of Section 274(d).

In this case and many similar others, petitioners have argued that the Cohan Rule (Cohan v. Commissioner, 39 F.2d 540, 543-544 [8 AFTR 10552] (2d Cir. 1930)[12] gives the court leeway to allow certain business expense deductions when receipts for business related events can be produced but no substantiation exists, and the court is satisfied that the expense had a business purpose. Courts have exclusively ruled that the strict substantiation requirements contained in Section 274(d) preclude use of the Cohan Rule for meals, entertainment, travel, and business use of listed property.[13]

The court ruled in this case to uphold both the disallowance of over $25,000 in business expense deductions and the understatement of tax liability related penalties of $1,623. Since the understatement of tax liability was greater than $5,000 they were required to pay a penalty.

Mr. Hentges clearly failed to properly document any of his business related expenses in accordance with Section 274(d). His reconstruction of events, dates, times, people, and places after the fact cost him over $25,000 in business expense deductions, provided they were bona fide business expenses, and untold attorney's fees. The fact that he showed at least a $21,000 loss on his Schedule C from his financial planning business most likely raised red flags with the IRS, causing his deductions to come into question.

Kevin P. Osborne v. Commissioner.[14]

Kevin Osborne was an insurance broker who ran a sole proprietorship. His case contested the IRS application of the 50 percent rule under Section 274 for what he called "business promotion expenses." Mr. Osborne contended that his business promotion expenses were fully deductible under Section 162 because they were ordinary and necessary expenses involved in the conduct of his business as an insurance broker.

According to records kept by Mr. Osborne himself, the majority of the expenses in question were incurred at restaurants and a country club. He also could not prove that the expenses listed in his records were not for meals and entertainment. The court found that his own summary of records supported the original finding that the expenses

were subject to the 50 percent rule.

An issue unrelated to the "business promotion expenses" but nonetheless significant and worth mentioning in the general context of business deductions is the loan repayment expenses that Mr. Osborne claimed on his Schedule C. These were payments on loans that Mr. Osborne made to himself as proprietor of his business; as such they were summarily disallowed since loan repayments to yourself are not deductible business expenses. (*Brenner v. Commissioner*, 62 T.C. 878 (1974); *Crawford v. Commissioner*, 11 B.T.A. 1299 (1928)).[15] The amounts claimed as loan repayments were significant; $30,000 each in 1996 and 1997.

Mr. Osborne argued that he placed reasonable reliance on his tax return preparer in assessing the deductibility of is business expenses and therefore was not subject to the accuracy related penalties imposed in an earlier court ruling. The court agreed with his argument and relieved him of the penalty.

Mr. Osborne could have saved himself a lot of trouble not only by engaging a CPA to prepare his taxes, but by becoming familiar with the tax law himself. Business owners should take prudent steps to educate themselves on allowable business deductions not only to ensure accurate preparation of tax returns, but to facilitate accurate record keeping and to facilitate tax planning for future years as part of an overall business plan. Most proprietors should not rely on franchised, non-CPA tax preparers because they don't have the same level of technical expertise as CPAs.

Barry Knelman et ux. v. Commissioner[16]

This is an interesting case of travel and meal expense deductions that were disallowed for Barry Knelman, a sole proprietor who owned a landscaping business in California. What is odd about this case is that Mr. Knelman maintained his permanent residence in Ohio, but operated a business in California. By his own admission he and his wife lived in Ohio purely as a result of their own preference.

At issue were Mr. Knelman's right to claim travel expenses for traveling from his home in Ohio to his place of business in California as Section 162 ordinary and necessary business expenses. Also at issue was the deductibility of meal expenses incurred in conjunction with the travel to California.

The court ruled in the original case that the travel and meal expenses were not deductible as business expenses because they represented commuting expenses incurred to travel from his home to his place of business; (Section 262). Commuting expenses from the home to one's place of business are non-deductible and no consideration is given to the distance traveled; (Commissioner v. Flowers).

Since the meal expenses were incurred in conjunction with commuting expenses, they were ruled non-deductible because they were deemed to be living expenses.

Mr. Knelman represented himself before the tax court and was not prepared to argue his case effectively before the court according to the case summary. Had he sought counsel, he probably would have been told by his lawyer that he had no reasonable basis for pursuing his claim. It would have been wise for him to have consulted a CPA or tax attorney before attempting to deduct travel and meal expenses that were actually commuting and living expenses.

Conclusion

After review and analysis of these cases, it is evident that the individual taxpayers and some of the corporate taxpayers were either not familiar with the tax law governing deductibility of business expenses or they were actively trying to circumvent the law.

The onus is on the taxpayer to provide corroborative substantiation under Section 274(d) or to provide evidence in support of their assertion that their expenses were ordinary and necessary expenses incurred in the conduct of business under Section 162. If more taxpayers knew this, they would take prudent steps to ensure that they made a reasonable attempt to document dates, times, places, people, and purpose. Several petitioners of the court made the mistake of trying to recreate records after the fact which did not meet the Section 274(d) requirement that records be made in close proximity to the time of the event.

The substantiation requirements of Section 274(d) are strict and objective in nature. Individual taxpayers and corporations are advised to become intimately familiar with the requirements or consult with a CPA or tax attorney in order to gain a sufficient understanding of the requirements. CPAs and tax attorneys can also provide competent advice on how to utilize business expense deductions as part of an overall tax planning strategy.

Review of tax court cases can be an invaluable tool for CPAs and tax attorneys in preparation for preparing returns, tax planning, or for representing a client before the IRS. It is recommended that all CPAs and tax attorneys utilize this invaluable resource to gain a solid understanding of case precedent affecting their clients, and to aid in their conduct of due diligence while providing professional services to their clients.

Endnotes

1. Hoffman, Willis, & Smith 2008 edition of *Individual Income Taxes*, pp. 9-18.

2. Churchill Downs, Inc., et al. 115 TC 279, code Sec(s) 274, (2000). Tax Court & Board of Tax Appeals Reported Decisions (1924–2005).

3. Rapid, Electric Co., Inc., 61 TC 232 (1973). Tax Court & Board of Tax Appeals Reported Decisions (1924–2005).

4. BJR CORP., 67 TC 111 (1976). Tax Court & Board of Tax Appeals Reported Decisions (1924–2005).

5. Ibid.

6. Ibid.

7. Mediaworks, Inc., v. Commissioner, TC Memo 2004-177, code Sec(s) 162; 274 (2004). Tax Court & Board of Tax Appeals Memorandum Decisions (1924–2005).

8. Ibid.

9. Ibid.

10. Michael E. Hentges et ux. V. Commissioner, TC Memo 1998–244, Code Sec(s) 274; 662 (1998). Tax Court & Board of Tax Appeals Memorandum Decisions (1924–2005).

11. Ibid.

12. Ibid.

13. Ibid.

14. Kevin P. Osborne, TC Memo 2002-11, Code Sec(s). 162; 274; 6662 (2002). Tax Court & Board of Tax Appeals Memorandum Decisions (1924–2005).

15. Ibid.

16. Barry Knelman et ux., TC Memo 2000-268, Code Sec(s). 61; 162; 6662 (2000). Tax Court & Board of Tax Appeals Memorandum Decisions (1924–2005).

17. Ibid.

18. Ibid.