Tax Law: Substantiation of Business Related Entertainment Expenses

Dennis J. McNally

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation
Available at: http://scholarship.law.marquette.edu/mulr/vol54/iss3/6

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.
COMMENTS
TAX LAW: SUBSTANTIATION OF BUSINESS RELATED ENTERTAINMENT EXPENSES

The individuality of professional men and the operators of small businesses, though often a key to their success, has long made the tasks of their business and tax advisers difficult. The difficulties arise from the reluctance of the professional man and small businessman to react to and to follow the suggestions of his advisers relating to compliance with statutory technicalities surrounding the corporate form and relating to the keeping of adequate records for tax purposes. When the Revenue Act of 19621 was passed, it contained detailed provisions relating to the substantiation of business entertainment expense deductions. Section 274(d) provided that an otherwise deductible business entertainment expense should not be allowed "unless the taxpayer substantiates by adequate record or by sufficient evidence corroborating his own statement" the amount, time and place and business purpose of each such expense and the taxpayer's business relationship to the persons entertained. The accountants and tax counsel of nearly every sizable business across the country immediately recognized the import of this newly enacted section and alerted their employers to it. Many businesses were already requiring extremely detailed reports of business related entertainment expenditures of their employees. Such reports were required for the very practical purpose of setting clear and stringent standards to be met by the employees as a condition precedent to reimbursement by their employers.

Many small businessmen and professional men did not react so quickly and completely either because they neglected to obtain tax counseling as a matter of course or chose to ignore what tax counseling they did obtain. The intent of this article is to review several recent decisions that involve business related entertainment expenditures by professional men and the operators of small businesses.

Petitioners Paul and Marion R. Heymann2 are husband and wife who filed a joint federal income tax return for the year 1965. The return, based upon the cash method of accounting, was filed on May 3, 1966. The Heymanns had a joint family membership at their local country club which was used by Mr. Heymann for the entertainment of his insurance clients and also by the Heymann family for recreational purposes. In 1965, the Heymanns' total expenditures at the club amounted to $1,691.21. The table checks, receipts and bills from the country

---

club contained no information showing a business purpose for any of
the expenses or the business relationship of the petitioner to those he
had entertained at the club.

Despite the fact that the petitioner had kept inadequate records to
substantiate his business expenses, the Internal Revenue Service allowed
him to deduct 60% of the $1,691.21 country club expenditure as a busi-
ness related travel and entertainment. Since the expenses were not
properly substantiated, the deduction must have been permitted under
the long followed "Cohan Rule" derived from the case of Cohan v.
Commissioner. In the Cohan case, evidence indicated that the petitioner
had incurred deductible expenses but their exact amounts could not be
determined. Rather than disallow the entire deduction, the court ruled
that it should make "... as close an approximation as it can ..."4
of the amount of the petitioners' deductible expenses and allow a deduc-
tion equal to the amount so approximated.

After the Internal Revenue Service had allowed the approximated
business expense deduction, it assessed the Heymanns a tax deficiency
for the year 1965 and also imposed a penalty based on Sections 6651(a)6

3 39 F.2d 540 (C.A. 2d, 1930).
4 Id. at 544.
6 SEC. 6651. FAILURE TO FILE TAX RETURN OR TO PAY TAX.
(Sec. 6651(a))
(a) ADDITION TO THE TAX.—In case of failure—

(1) to file any return required under authority of subchapter A of
chapter 61 (other than part III thereof), subchapter A of chapter 51 relat-
ing to distilled spirits, wines and beer), or of subchapter A of chapter 52
(relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of
subchapter A of chapter 53 (relating to machine guns and certain other
fire-arms), on the date prescribed therefor (determined with regard to any
extension of time for filing), unless it is shown that such failure is due to
reasonable cause and not due to willful neglect, there shall be added to the
amount required to be shown as tax on such return 5 percent of the amount
of such tax if the failure is for not more than 1 month, with an additional
5 percent for each additional month or fraction thereof during which such
failure continues, not exceeding 25 percent in the aggregate:

(2) to pay the amount shown as tax on any return specified in para-
graph (1) on or before the date prescribed for payment of such tax (deter-
mined with regard to any extension of time for payment), unless it is
shown that such failure is due to reasonable cause and not due to willful
neglect, there shall be added to the amount shown as tax on such return
0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional
0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate; or

(3) to pay amount in respect of any tax required to be shown on a
return specified in paragraph (1) which is not so shown (including an
assessment made pursuant to section 6213(b) within 10 days of the date of
the notice and demand therefore, unless it is shown that such failure is
due to reasonable cause and not due to willful neglect, there shall be added
to the amount of tax stated in such notice and demand 0.5 percent of the
amount of such tax if the failure is for not more than 1 month, with an
additional 0.5 percent for each additional month or fraction thereof during
which such failure continues, not exceeding 25 percent in the aggregate.
SEC. 6653. FAILURE TO PAY TAX.
(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME OR GIFT TAXES. —If any part of any underpayment (as defined in subsection (c) (1) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

7 Internal Revenue Code of 1954, Section 274(d) and Treasury Regulation 1-274-5(a) (1962).

8 SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(d) SUBSTANTIATION REQUIRED. —No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) 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 an activity, or

(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

9 Sec. 1-274-5. Substantiation requirements.
(a) In general. No deduction shall be allowed for any expenditure with respect to—

(1) Traveling away from home (including meals and lodging) deductible under section 162 or 212,

(2) Any 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 an activity including the items specified in Section 274(e), or

(3) Gifts defined in section 274, unless the taxpayer substantiates such expenditure as provided in paragraph (c) of this section. This limitation supersedes with respect to any such expenditure the doctrine of Cohan v. Commissioner (C.C.A. 2d, 1930) 39 F.2d 540. The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expenses but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction shall be allowed a taxpayer for such expenditures on the basis of such approximations or unsupported testimony of the taxpayer. For the purposes of this section, the term "entertainment" means entertainment, amusement, or recreation, and use of a facility therefor; and the term "expenditure" includes expenses and items (including items such as losses and depreciation).
expenses. The reason given for this ruling as opposed to adhering to
the approximation rule of the Cohan case\footnote{10} is that the rule of Cohan
was explicitly overruled in respect to unsubstantiated business expenses
in the case of Sanford v. Commissioner.\footnote{11}

The Sanford case involved a petitioner who was employed as an
advertising salesman and was paid a salary adequate to cover his non-
reimbursable business related travel and entertainment expenses. When Sanford filed his tax return for the year 1963, the Com-
missioner of Internal Revenue disallowed deduction of all alleged
but non-receipted travel and entertainment expenses that exceeded
$25.00 per expenditure. The position of the Commissioner, upheld by
the Second Circuit Court of Appeals,\footnote{12} was that Sanford had failed to
meet the two-fold test for qualification of business and travel expense
deductions. In order to qualify as a deduction, such an expense (1)
must be shown to have been incurred as an ordinary and necessary
incident of carrying on a trade or business\footnote{13} and (2) must be properly
substantiated.\footnote{14} Petitioner Sanford claimed to have met the substantia-
tion requirements of Section 274(d)\footnote{15} by keeping a desk calendar list-
ing the persons entertained, the entertainment facilities, the amount
spent and the date of expenditure. The purpose of the entertainment
was not listed nor was the calendar accompanied by receipts from the
entertainment facilities. This method of record keeping for non-reim-
bursed expenses was in marked contrast to the detailed expense reports
and receipts that Sanford tendered to his employer to substantiate re-
imbursable expenses. The position of the Internal Revenue Service that

\footnote{10} Note 2, supra.
\footnote{11} Sanford v. Commissioner, 50 T.C. 823 (1968), aff'd. 412 F.2d 201 (C.A. 2d
\footnote{12} Id.
\footnote{13} SEC. 162. TRADE OR BUSINESS EXPENSES.
(Sec. 162(a))

(a) IN GENERAL.—There shall be allowed as a deduction all the ordi-
nary and necessary expenses paid or incurred during the taxable year in
carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for per-
sonal services actually rendered;
(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;
and
(3) rentals or other payments required to be made as a condition to the
continued use or possession, for purposes of the trade or business, of
property to which the taxpayer has not taken or is not taking title or in
which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member
of Congress (including any Delegate and Resident Commissioner) within the
State, congressional district, Territory, or possession which he represents in
Congress shall be considered his home, but amounts expended by such Mem-
bers within each taxable year for living expenses shall not be deductible for
income tax purposes in excess of $3,000.

\footnote{14} Note 8, supra.
\footnote{15} Id.
all deduction for business entertainment expenses exceeding $25.00 per expenditure\textsuperscript{16} must be substantiated by adequate records or by sufficient evidence corroborating the taxpayers' own statements as to:

1. the amount of such expense
2. the time and place of such expense
3. the business purpose of such expense
4. the business relationship of the taxpayers to the persons entertained was based on Section 274(d)(2) of the Internal Revenue Code of 1954. The section sets forth the above requirements and authorizes the Commissioner of Internal Revenue to set a dollar limit for expenditures, below which limit some or all of the substantiation requirements need not be met in order for a taxpayer to claim and properly substantiate a business deduction. The court disallowed any part of Sanford's claimed deduction, citing the language of the United States Senate Report\textsuperscript{17} which clearly indicates that the substantiation requirements of Section 274 were intended to overrule the approximation rule of Cohan in respect to deductions claimed for business entertainment travel and gift expenditures. The language is explicit when it states that, if an expenditure is not properly substantiated, it "would be disallowed entirely"\textsuperscript{18} rather than approximated. Although the court indicated that the new substantiation role could be met by something less than adequate written records of the taxpayers, Sanford made no attempt to use "other sufficient evidence" such as testimony or written statements of witnesses that corroborated his own written statements and deficient records.\textsuperscript{19}

\textsuperscript{16} \textit{Int. Rev. Code} of 1954, § 274(d) provides:
\begin{quote}
"The Secretary or his delegate may be regulations provides that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations."
\end{quote}

Treasury Regulation 1.274-3(a) establishes the actual dollar amount:
\begin{quote}
"(a) In general. No deduction shall be allowed under section 162 or 212 for any expense for a gift made directly or indirectly by a taxpayer to any individual to the extent that such expense, when added to prior expenses of the taxpayer for the gifts made to such individual during the taxpayer's taxable year, exceeds $25."
\end{quote}


\textsuperscript{18} \textit{Id.}

\textsuperscript{19} Treasury Regulation 1.274-5(c)(3) (1962).

"(3) Substantiation by other sufficient evidence. If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements of sub-paragraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element—

(i) By his own statement in writing containing specific information in detail as to such element, and

(ii) By other corroborative evidence sufficient to establish such element. If such element is the description of a gift, or the cost, time, place or date of an expenditure, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witness setting forth detailed information about such element, or the
ford could also have escaped the strict substantiation requirements that caused the disallowance of his deductions if he had been able to show that the "inherent nature" of the situation in which the expenditure was made prevented him from meeting the "other sufficient evidence" requirement but that the other evidence he did present with respect to such element possessed the highest degree of probative value possible under the circumstances. The substantiation by "other sufficient evidence" authorized by Treasury Regulation 1.274-5(c)(3) and (4) and alluded to in Sanford was treated at greater length and with more clarity in the LaForge case. Doctor LaForge was a surgeon who regularly purchased luncheons for residents and interns who assisted him. The luncheons were bought in a hospital cafeteria that issued no receipts and LaForge kept no records of the expenditures. Despite the lack of substantiation or record, LaForge treated these expenditures as business entertainment expenses and deducted $2.00 per day for each day he worked in the hospital. These deductions were made on the taxpayer's 1964 and 1965 tax returns. The Internal Revenue Service conceded that the deduction met the substantive requirements of Sections 162 and 274 of the Internal Revenue Code of 1954 but contended that testimony of the taxpayer and of the cafeteria cashier failed to satisfy the "substantiation by other sufficient evidence" requirements of Treasury Regulations 1.274-5(c) because the taxpayer had neither kept a contemporaneous written record nor filed a written statement containing specific detail as to the elements of the expenditures. The deductions were thus completely disallowed. The taxpayer contended that the requirement of Treasury Regulation 1.274-5(c)(3)(i) demanding a written statement of claimed business related entertainment expenditures exceeds the statutory requirement of substantiation by "sufficient evidence corroborating his own statement." The Court agreed, stating

---

20 Treasury Regulation 1.274(c)(4) 1962.

"(4) Substantiation in exceptional circumstances. If a taxpayer establishes that, by reason of the inherent nature of the situation in which an expenditure was made—

(i) He was unable to obtain evidence with respect to an element of the expenditure which conforms fully to the "adequate records" requirements of sub-paragraph (2) of this paragraph,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the "other sufficient evidence" requirements of subparagraph (3) of this paragraph, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph."


23 Int. Rev. Code of 1954, § 274(d), note 8, supra.
that such a regulation negated the legislative intent of the statute which contemplated substantiation by oral testimony. The intent of Congress is outlined by the following:

The degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer together with circumstantial evidence available, may be considered "sufficient evidence" for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be "sufficient evidence" as to the amount of an expense.\(^{24}\)

In *LaForge*, because the taxpayer had failed to provide testimony as to the cost of his own lunches which were not deductible and would have to be subtracted from his daily total cafeteria expenditure to determine the amount of the deductible daily expenditure, the case was remanded to the Tax Court for such a determination.

Another important principle that is enunciated in *La Forge* and bears directly on the affairs of small business and professional men is the rule that:

1. facility expenditures are deductible only if the taxpayer establishes that the club or facility was used "primarily for the furtherance of the taxpayer's trade or business," and
2. the expenditures were "directly related to the activity of the taxpayer's trade or business."\(^{25}\)

The rule applies to club dues because they are considered as facility expenditures.\(^{26}\) Once a taxpayer has established that such facility expenditures as club dues were expended primarily in furtherance of


\(^{25}\)INT. REV. CODE of 1954, § 274(a) (1) (A) and (B).

SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC. (Sec. 274(a))

(a) ENTERTAINMENT, AMUSEMENT OR RECREATION 0

(1) In General—No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) ACTIVITY.—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or in case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) FACILITY—With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business, and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise) the portion of such item associated with, the active conduct of the taxpayer's trade or business.

\(^{26}\)Note 24, supra.
his business, the taxpayer may deduct, as a business entertainment expense, the portion of the club dues or facility expenditures directly related to the furtherance of the taxpayer's business or profession.

Harry LaForge had shown that his club dues were primarily expended for furtherance of his profession, but the portion of the dues directly related to this purpose was disputed. A taxpayer may deduct that fraction of the total dues that corresponds to the percentage which the taxpayer's expenditures for business meals taken at the club represent of his total yearly expenditure for food and beverages purchased at the club. The expenditures for professional and family purposes were easily discernible, but the taxpayer claimed that the cost of his own meals in conjunction with professional entertaining should be included with the total business expenses, increasing the proportion of the club dues that would be deductible. The Tax Court excluded these amounts, ruling that the cost of the taxpayer's own meals was not "directly related" to the conduct of his medical practice and thus could not be used to increase the deductible portion of the dues. The Second Circuit Court of Appeals disagreed, saying that such expenditures were "directly related" to his practice because the dues represented the cost of the taxpayer's access and the access of his guests to the facilities of the club and his presence was a pre-requisite to the finding that expenditures for entertainment at the club were for business entertainment. Thus, expenditures for his own meals when entertaining for business purposes were "directly related", deductible, and to be considered in the determination of the deductible portion of the club dues.

While the LaForge decision clearly indicates that oral testimony can be used to corroborate the taxpayer's statements as to business entertainment expenditures and overrules the "written statement" requirement of Treasury Regulation 1.274-5(c)(3)(i), these pronouncements are only effective in the second judicial circuit. In addition, the Court failed to set forth any standards relating to such oral testimony but remanded the case to the Tax Court.

The first pronouncement by the Tax Court on the subject of oral testimony following the LaForge decision is contained in the Fiorentino case,27 a memorandum decision denying a taxpayer's petition for modification of the Tax Court's memorandum findings of fact and opinion, or, in the alternative, seeking admission of new evidence in a case earlier decided which involved the deductibility of expenses incurred in the operation of a boat. Taxpayer Imero O. Fiorentino presented his own oral testimony corroborated by that of his secretary and two business associates in an attempt to substantiate the expenses incurred in the use of his privately owned pleasure boat as a business expense de-

duction. Fiorentino's petition was based on the ruling of the Second Circuit Court of Appeals in the LaForge case that oral testimony "properly corroborated" may fulfill the alternative substantiation requirements of Section 274(d) of the Internal Revenue Code of 1954. The Tax Court denied Fiorentino's motion and concluded that the oral testimony failed to show that the boat was used primarily for the furtherance of the taxpayer's business and that it also did not establish the number of people entertained on the boat, their business relationship to Fiorentino and the number of times the boat was used for business entertainment. Thus, the Tax Court seems to be saying that although oral testimony of others may be used to substantiate business expenses for which the taxpayer has not kept adequate records, such oral testimony must meet the substantiation requirement of Section 274(d) of the Internal Revenue Code of 1954 and Treasury Regulation 1.274-5 (b) (1) which require that the taxpayer substantiate all elements of an expenditure and defines such elements as:

1. amount
2. time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of gift;
3. business purpose; and
4. business relationship to the taxpayer of each person entertained using an entertainment facility or receiving a gift. 28

The tax consequences suffered by J. D. Whitt 29 and Robert J. Hays 30 are typical of those that await the commission salesman, professional man or small businessman who fails to substantiate business entertainment expenses.

Hays, a sales manager for a large manufacturing corporation, earned his income largely through commission sales. He traveled extensively visiting the corporation's sales distributorships scattered throughout the country. During the tax year of 1967, Hays claimed he had spent $12,128.20 on business travel and entertainment of the distributors at cocktails, business meals and other business entertainment including golf. Hays submitted business travel expense vouchers to his employer substantiating the fact that he had spent $9,567.33 and was reimbursed


"(b) Elements of an expenditure—(1) In general. Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless taxpayer substantiates the following elements for each expenditure:

(i) Amount:
(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift:
(iii) Business purpose; and
(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift."


by his employer for the entire amount. Hays claimed the remaining $2,560.87 as non-reimbursed business entertainment expense on Form 2106 for taxable 1967. Hays failed to substantiate any of his claimed business entertainment expense deductions because he had kept no record of his business entertainment activities nor had he retained any of the receipts from the facilities at which the entertainment was conducted. He kept only a diary that listed the date on which he had been at a particular city and the name of the distributorship with which he had worked on each visit. The Internal Revenue Service allowed a deduction of only $500.00 automobile expenses and disallowed the remainder. Hays and his wife appealed the ruling to the Tax Court, sitting in the First Judicial Circuit, which ruled that Hays had failed to make the required substantiation either by adequate records or by sufficient evidence corroborating his own statements. The diary kept by Hays clearly did not meet the substantiation requirements of Section 274(d) of the Internal Revenue Code of 1954. The Tax Court cited Sanford as authority for the substantiation ruling and LaForge in refusing to recognize the taxpayer's brief diary as "sufficient evidence" to corroborate his "self-serving" oral testimony.

The attitude responsible for Hays' plight is best illustrated by his own words taken from the record of the Tax Court:

"(It is) unreasonable for people in my position to be expected to keep that type of record (as required by Section 274(d))."

J. D. Whitt was the sales manager of an automobile dealership in the southwestern part of the United States. He traveled the area in search of sales, entertaining prospects and attending sales conferences. The taxpayer kept no record of his travels, nor did he retain receipts for his entertainment expenses. Whitt and his wife deducted a total of $1,945.00 as business related expenses on their joint federal income tax return for the year 1967. The total deduction was divided into several categories which were labeled "luncheon and coffee", "entertainment before and after business and sales conferences", "home entertainment following sales and business contacts", and "travel to conventions, sales meetings, etc." The Internal Revenue Service disallowed the entire business expense deduction on the grounds that the petitioners had failed to meet the record keeping and substantiation requirements of Section 274 of the Internal Revenue Code of 1954.

On appeal, the Tax Court, sitting in the First Judicial Circuit, upheld the disallowance by the Internal Revenue Service, pointing to a stipulation entered by the petitioners stating that they had failed to maintain any concurrent records relating to the time, business purpose or the

31 Form 2106 Statement of Employee Business Expenses.
32 Note 11, supra.
33 Note 21, supra.
34
amount of travel and entertainment expense deduction claimed on the 1967 tax return. In addition, petitioner Whitt frankly admitted that the amounts claimed in the various categories of his total business expense deduction were estimates. The only substantiation evidence submitted by Whitt was a series of cancelled checks purporting to show that he had actually incurred the amount of expenditures that he claimed. Many of the checks were simply made out to Gordon Rountree Motors, Ltd., Whitt’s employer, as payee. The petitioner claimed that he had cashed these checks “for various things” and admitted that it was conceivable that some of the money was for personal expenditures. To this evidence the Tax Court replied that Whitt may well have made some expenditures in the course of business entertainment, but that the Sanford case clearly overrules the approximation rule of the Cohan and that without proper substantiation no deduction could be allowed the petitioner for his claimed business travel and entertainment expense. The Court also cited the LaForge case in rejecting the argument of the petitioner that the cancelled checks he submitted as evidence could be considered as “sufficient evidence” to corroborate his otherwise uncorroborated and self-serving testimony.

Petitioner Whitt argued that his federal income tax return for the year 1964 had been audited and that his deductions for business expenditures were allowed, presumably without written or other detailed substantiation, and that this allowance had set a precedent for subsequent years. To this argument, the Tax Court clearly stated that the failure of a revenue agent to find and disallow an improper deduction does not prevent the Internal Revenue Service from contesting the same type of deduction taken in another year.

The illustrative cases of J. D. Whitt and Robert J. Hays serve as notice that the Internal Revenue Service and the Tax Court clearly intend to enforce Sanford’s interpretation of the stringent substantiation requirements of Section 274(d) of the Internal Revenue Code of 1954 and also that the service and courts are aware of the ruling in LaForge but recognize that the “other sufficient evidence” must contain all the elements of substantiation required by Section 274.

In summary, small businessmen, commission salesmen, and professional men should be counseled to keep adequate records to substantiate their business entertainment expenses. This is certainly easy to do and the taxpayer is aided in this task by a multitude of available materials such as calendars, diaries and expense report books that list the various categories that must be recorded in order to meet the requirements of

35 Note 11, supra.
36 Note 3, supra.
37 Note 21, supra.
38 Note 29, supra.
39 Note 30, supra.
the Internal Revenue Service. The business entertainer often needs only to make a few brief notes on the form provided on the reverse side of the receipt he receives when using his credit card. Since it is both easy and convenient to do so, no business entertainer should fail to adequately substantiate his business entertainment expenses in a contemporaneous fashion. Doing so will make it unnecessary for the taxpayer to depend on the oral substantiation requirement of the Treasury Regulations which are as stringent in their elements as are the written substantiation requirements. In addition, the ruling that a taxpayer need not furnish written statements of business expenses to coincide with the oral testimony of witnesses theoretically only applies in the Second Judicial Circuit. One must also be aware that a problem of practicality arises if a taxpayer who frequently entertains for business reasons attempts to substantiate a large portion of his expenditures using the oral testimony of countless numbers of those entertained.

The taxpayer must contemporaneously record the following elements of each business entertainment expense that exceeds $25.00:

1. Cost
2. Date of entertainment
3. The place of entertainment (or use of a facility with respect to entertainment), including address, location and a description of the entertainment if not readily apparent.
4. Business purpose; and
5. Business relationship to the taxpayer of each person entertaining or using the entertainment facility.

The taxpayer must also meet the second part of the two-fold test for a business entertainment expense deduction by showing that the expense was incurred as a "ordinary and necessary" expense in the carrying on of his trade or business.

That taxpayer should be cautioned that deduction of part of the operating expenses of an entertainment facility that he owns (a boat or cottage) or to which he belongs (a country club) is deductible only in proportion to the amount for which it is used for business entertainment purposes, and this rule is further qualified by the fact that the facility must be used substantially (over 50 percent) before any such deduction is allowed at all.

Since businessmen throughout the country meet the stringent substantiation requirements of their employers in order to obtain reimbursement for expenditures, it would seem that the similar tests of the Internal Revenue Code can be met in the case of nonreimbursable expenses if these requirements and the penalty for failing to meet them is known.

DENNIS J. McNALLY

---

40 Treasury Regulation 1.274-5(c)(3) (1962), note 19, supra.