

## Deductions--Business Expenses

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# TAXATION

## DEDUCTIONS — BUSINESS EXPENSES

The Internal Revenue Code of 1954 specifically prohibits deductions from income for "personal, living or family expenses."<sup>1</sup> The Regulations promulgated under the Code provide that no deduction should be allowed in respect to personal, living or family expenses except as expressly provided in the Code.<sup>2</sup> Express Code prohibition would seem to be unnecessary since the definition of expenses which are personal is the very antithesis of the concept of expenses incurred in carrying on a trade or business.<sup>3</sup> Despite this apparent dichotomy the individual wage earner has often attempted to characterize his disbursements as deductible business expenses. This term in *Newi v. Commissioner*<sup>4</sup> the court allowed the taxpayer a deduction for the portion of the rent, light and cleaning of his apartment as an ordinary and necessary business expense. Newi was an outside salesman of network television time. He had partitioned a room in his apartment so that he had a private study in which to work three or four hours a night, reviewing his notes and plan-

<sup>1</sup> INT. REV. CODE OF 1954, § 262. This provision was enacted as a safeguard against the popular idea that any amount expended in earning income would ordinarily be deductible. See, e.g., Walter M. Sheldon, 30 P-H TAX CT. MEM. 256 (1961), *aff'd*, 299 F.2d 48 (7th Cir. 1962).

<sup>2</sup> Treas. Reg. § 1.262-1 (1960). Items which are considered to be personal, living or family expenses include: premiums paid on life and on dwelling insurance; expenses incurred in order to maintain a household; losses sustained on property held for personal, living or family purposes; amounts paid for breach of promise to marry; and professional fees and related costs paid in connection with separation or divorce. *Id.*

<sup>3</sup> Section 162(a) of the 1954 Code allows a deduction from gross income for ordinary and necessary expenditures "directly connected with or pertaining to the taxpayer's trade or business." Treas. Reg. § 1.162-1(a) (1960). By section 161 of the Code the deductions allowed in section 162 as ordinary and necessary business expenses are deductible in computing *taxable income*. Section 62 of the Code provides that some trade and business deductions of employees (reimbursed expenses, expenses for travel away from home, transportation expenses, and expenses incurred in solicitation of business as an outside salesman) are to be deducted from gross income in arriving at *adjusted gross income*. The differentiation of those expenses deductible from gross income used to compute adjusted gross income from the expenses of section 162 used to compute taxable income is of some significance. Adjusted gross income is used as the basis for determining, *inter alia*, the amount of the standard deduction [under section 141], the limitation on the amount of the deduction for charitable contributions [under section 170(b)(1)], the limitation of the amount of the deduction for medical and dental expenses [under section 213], and, in certain cases, the limitation on the deduction for expenses of care of certain dependents [see section 214].

Under section 212 similar expenses may be deducted by individuals not engaged in a trade or business if incurred "for the production or collection of income" and "for the management, conservation, or maintenance of property held for the production of income." For the most exhaustive study of cases in connection with section 212, see 4A MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 25A.01-21 (1959) [hereinafter MERTENS]; see also Kilbouron, Jr., *Deductible Expenses: Transactions Entered into for Profit; Income Producing Property*, 21 N.Y.U. 21ST INST. ON FED. TAX 193 (1963); Libin, *Deductibility of Settlement Payments Under Section 212*, 40 TAXES 718 (1962).

<sup>4</sup> 432 F.2d 998 (2d Cir. 1970).

ning the next day's agenda.<sup>5</sup> Although his employer did not require or request the taxpayer to set aside a portion of his apartment for office work and it was conceded that the employer's building was open in the evening with office space and television equipment available, the court indicated that it would be "wholly impractical" for the taxpayer to work at night in the office rather than at home.<sup>6</sup> The court relied on the Treasury Regulation which allows a deduction for residential expenses for that portion of the house used as a place of business.<sup>7</sup> The Commissioner alleged that the construction of Section 162(a) of the Code, as applied in this case, would alter the requirements for determining the deductibility of an expense from the standard contemplated by Con-

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<sup>5</sup> The taxpayer had been forced to change apartments with the advent of a child and moved into another apartment in the same building in which he again partitioned off an area to use as a study. As the sale of television time required the use of a television, the room was equipped with such. However, the study or television was not used by the taxpayer or his wife for personal entertaining or personal television viewing. *Id.* at 999.

<sup>6</sup> *Id.* at 1000. The court denied the Commissioner's argument that the employer's building was actually closer to the taxpayer's clients than to the room in the taxpayer's apartment. *Id.* Since no business calls to advertising agencies could be made during evening hours and the taxpayer might also miss some television programs important to his business if forced to travel back to his office after having dinner at home, the court discounted the alternatives available to Newi. *Id.*

<sup>7</sup> Treas. Reg. § 1.262-1(b)(3) (1960). "A taxpayer who rents a property for residential purposes, but *incidentally* conducts business there (his place of business being elsewhere)" shall not deduct any part of his rent. If, however, he uses "part of the house as his *place of business*, such portion of the rent and other similar expenses as is properly attributable to such place of business is deductible as a business expense." *Id.* (emphasis added).

As the Regulation suggests, expense of operating a residence will ordinarily be viewed as personal expenses. See, e.g., *Ida Gevritz*, B.T.A. Mem. Op., No. 27637 (1940). *But cf.* *James L. Dowsey*, B.T.A. Mem. Op., No. 97392 (1940). See also *Rumsey v. Commissioner*, 82 F.2d 158 (2d Cir. 1936), *cert. denied*, 299 U.S. 552 (1936).

The burden of proof is on the taxpayer. He must establish that he has used space and facilities of his personal residence for the performance of his duties as employee, and must prove the pro rata portion of the depreciation and expenses incurred in the maintenance of his residence which represent the cost attributable to such use. The taxpayer should maintain records to substantiate his deduction, e.g., cancelled checks, bills and receipts. Items such as rent, light, taxes, cleaning and interest on a mortgage may be deductible in their pro rata share. However, such expenses that are normally peculiar to a residence, as opposed to an office, such as landscaping or lawn care, are not deductible. The basis for computing the depreciation allowable on that portion of the residence used for business purposes is the lesser of the fair market value or the adjusted basis of the entire residence (excluding land) at the time of conversion to business use. The area set aside for business purposes does not have to be used exclusively to that end. However, use of the particular area must be more than incidental or occasional. The basis for a pro ration of expenses may be any reasonable method under the circumstances, such as the proportion of square feet used as compared to the total square feet or the number of rooms set aside as compared to the total number of rooms in the residence. If the area is not used exclusively for business purposes a further allocation must be made. For detailed examples of the allocation of expenses incurred in connection with the use of a personal residence for business purposes see Rev. Rul. 62-180, 1962-2 CUM. BULL. 52. For what may be considered the outer parameter of the scope of this pro ration rule see I.T. 3929, 1948-2 CUM. BULL. 29, wherein a professional writer who maintained an office in a residence was allowed to deduct a portion of the expense incurred in protecting his residence from impeding fire.

gress.<sup>8</sup> The court denied this, stating that the decision is controlling solely upon the present case decided upon the peculiar facts as presented.<sup>9</sup> Notwithstanding the court's express language to the contrary,<sup>10</sup> its decision appears to change the requirements for deductibility of such expenses from the strict "ordinary and necessary" test and follow the current trend toward the more lenient standard of "appropriate and helpful."<sup>11</sup>

<sup>8</sup> 432 F.2d at 1000. Section 162(d) applies a test of "ordinary and necessary." The government argued that another standard would be implied by this decision, "appropriate and helpful," and that such a construction "would open the doors for a business deduction to any employee who would voluntarily choose to engage in an activity at home which conceivably could be helpful to his employer's business." *Id.* quoting Brief for Appellant at 11, 12.

<sup>9</sup> This pronouncement is similar to that of the Internal Revenue Service concerning the effect of Revenue Rulings. *See, e.g.,* Intro., 1970-2 CUM. BULL. xvii: "Revenue Rulings represent the conclusions of the Service on the application of the law to the entire state of facts involved."

<sup>10</sup> "This case opens the doors [for a business deduction] just long enough to enable this Taxpayer to pass through it into his cloistered study to pursue his business." 432 F.2d at 1000.

<sup>11</sup> The Commissioner's fear stems from recent cases which have relaxed the "ordinary and necessary" standard. The strict "condition of employment" rule of Rev. Rul. 62-180, 1962-2 CUM. BULL. 52, has not been consistently followed by the cases. The Second Circuit, as far back as 1934, relaxed the "ordinary and necessary" requirements, interpreting the standard in such a way that ". . . it means 'appropriate and helpful.'" *Blackmer v. Commissioner*, 70 F.2d 255, 256 (2d Cir. 1934). Recent cases have also rejected the strict interpretation. In *Herman E. Bischoff*, 25 CCH Tax Ct. Mem. 538 (1966), a television art director employed by an advertising firm maintained a home studio for after-hours work although he was provided an office. Overtime work (for which he received no additional compensation) was frequently necessary and it was more convenient to work at home. The court allowed a proportionate amount of the maintenance costs of the home studio, holding that

[i]t to be deductible as an ordinary and necessary business expense, it is sufficient that the expenditure be "appropriate and helpful" to the conduct of business; it need not be "required."

*Id.* at 539.

The *Bischoff* court cited Clarence Preiss, 40 T.C. 78 (1963), which allowed a college professor, whose office was not conducive to work, an allocable deduction from his home office. The government acquiesced in *Preiss*, which led to the conclusion that the standard of Rev. Rul. 62-180 would no longer be insisted upon by the Service. *See Lewis, IRS and Courts Adopting More Liberal Views Toward Professors' Home Office Expenses*, 24 J. TAXATION 232 (1966); *Oliver, The Deductibility of Expenses: A Professor's Research and a Study in His Home*, 50 A.A.U.P. BULL. 14 (1964). *See also* Martha E. Henderson, 37 P-H Tax Ct. Mem. 130 (1968). However *Newi* has now discharged that idea. (*See also* cases subsequent to *Newi*, in which the Service continued its insistence upon the standard of Rev. Rul. 62-180, Marvin L. Dietrich, 30 CCH Tax Ct. Mem. 1971-159 (July 15, 1971), and Walter W. Hendrix, Jr., 30 CCH Tax Ct. Mem. 1971-49 (April 9, 1971).

Perhaps no clear interpretation of "ordinary and necessary" can be made. *See* 4A MERTENS § 25.01. It has been said that there is no "verbal formula that will supply a ready touchstone" as to when an expense is ordinary and necessary. *Welch v. Helvering*, 290 U.S. 111, 115 (1933). "Ways of conduct and the forms of speech prevailing in the business world" may furnish a reliable guideline for the taxpayer in determining if his expenses is an ordinary expense of the business. *Id.* The taxpayer might well ask himself "what the average hardheaded businessman would have done under like circumstances." 4A MERTENS § 25.07. Yet these suggested tests cannot be relied upon as the standard to be applied in a particular set of facts. When it is appreciated that the term "ordinary"

The same section of the Code upon which *Newi* was decided, Section 162,<sup>12</sup> provides for a deduction for "travelling expenses . . . while away from home in the pursuit of a trade or business."<sup>13</sup> The expense must be reasonable and necessary, incurred while away from home, and in pursuit of business.<sup>14</sup> In *Rosenspan v. United States*,<sup>15</sup> the Second Circuit held that the taxpayer, a salesman who did not maintain a permanent residence since he travelled some three hundred days a year, did not have a "home" to be away from, thereby not satisfying the second prerequisite for deductibility.<sup>16</sup> *Rosenspan* travelled most of the year

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must be defined by "life in all its fulness" (*Welch v. Helvering*, 290 U.S. 111, 115 (1933)), it is easily understood why there will continue to be a mass of litigation over the meaning of the expense provisions of the statute.

<sup>12</sup> See note 3, *supra*.

<sup>13</sup> INT. REV. CODE OF 1954, § 162(a)(2). What is now section 162(a)(2) was brought into the tax structure by section 214 of the Revenue Act of 1921, 42 Stat. 239. Before 1921 section 214 had allowed a deduction of "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business," without further specification. Revenue Act of 1918, 40 Stat. 1066 (1918). In T.D. 3101, 3 CUM. BULL. 191 (1920), the Treasury Department interpreted the statute to allow deductions of "travelling expenses, including railroad fares, and meals and lodging in an amount in excess of any expenditures ordinarily required for such purposes when at home." *Id.* Mim. 2688, 4 CUM. BULL. 209 (1921) gave guidelines for determining what expenditures were "ordinarily required." Basically, the taxpayer was to compute his pro rata share of the total costs of maintaining a home for all persons in the household. This figure would thus represent the base for determining the excess amount of expenses incurred while not at home. However, the Treasury Department had some difficulty in administering the "excess" provisions of its Regulations, and asked Congress to grant a deduction for the "entire amount" of such meal and lodging expenditures. See Statement of Dr. T.S. Adams, Tax Adviser, Treasury Department, in Hearings on H.R. 8245 before the Senate Comm. on Finance, 67th Cong., 1st Sess., at 50, 234-235 (1921). The 1921 amendment, inserting section 162(a)(2)'s allowance of a deduction for the entire amount of qualified meals and lodging was therefore instituted to provide "a measure of justice" to commercial travelers. Representative Hawley, a member of the Committee on Ways and Means, 61 CONG. REC. 5201 (1921). See also the remarks of Senator Walsh, a member of the Committee on Finance, 61 CONG. REC. 6673 (1921). The Revenue Act of 1962, 76 Stat. 960, amended the provisions so that the amount expended for meals and lodging was limited to expenditures "other than amounts which are lavish or extravagant under the circumstances." *Id.* at 976-77.

<sup>14</sup> *Commissioner v. Flowers*, 326 U.S. 465 (1946). The Supreme Court said that (t)hree conditions must thus be satisfied before a traveling expense deduction may be made under [section 162]:

(1) The expense must be a reasonable and necessary travelling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while travelling.

(2) The expense must be incurred "while away from home."

(3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

*Id.* at 470.

<sup>15</sup> 438 F.2d 905 (2d Cir. 1971).

<sup>16</sup> The requirement that the expense be incurred away from home has been the subject of much litigation and debate. Many definitions of the term "home" have been offered. See, e.g., the dissenting opinion of Justice Douglas in *Commissioner v. Stidger*, 386 U.S. 287 (1967) ("home" construed to mean residence, so long as the residence

throughout the Midwest, where he would stay at hotels and eat at restaurants. He was not reimbursed by his employers. Periodically he would return to New York, performing essential duties at his employers' offices.<sup>17</sup> The taxpayer contended that for tax purposes his home was his "business headquarters," *i.e.*, where his employers' maintained their offices.<sup>18</sup> The Commissioner felt that "home," under these circumstances, should be understood as connoting a permanent abode.<sup>19</sup> The court

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is established as near to the place of employment as is reasonable, 386 U.S. at 297; *Wills v. Commissioner*, 411 F.2d 537 (9th Cir. 1969) ("home" of professional baseball player deemed to be the team's home area); *Commissioner v. Mooneyhan*, 404 F.2d 522 (6th Cir. 1968) ("home" of taxpayer away temporarily designated at principal place of employment). *See also* *James v. United States*, 308 F.2d 204 (9th Cir. 1962); *Burns v. Gray*, 287 F.2d 698 (9th Cir. 1961); *United States v. LeBlanc*, 278 F.2d 571 (5th Cir. 1960); *O'Toole v. Commissioner*, 243 F.2d 302 (2d Cir. 1957); *Coburn v. Commissioner*, 138 F.2d 763 (2d Cir. 1943); *Duncan v. Commissioner*, 17 B.T.A. 1088 (1929); 4A MERTENS § 25.82.

<sup>17</sup> Rosenspan returned to New York five or six times a year. He gave his brother's Brooklyn home as his residential address, registering, voting and filing his income tax returns from that address. Although he left some personal items, such as clothing at his brother's home, Rosenspan most often stayed at a hotel. Annual vacations were spent in Brooklyn. His automobile was registered, however, in Ohio, a cousin's address being given. Mail was received in Ohio. 438 F.2d at 907. While in New York the salesman would clean up his sample case, check orders, discuss customers' credit problems, recommend changes in stock, attend staff meetings, and perform similar duties. *Id.*

<sup>18</sup> Rosenspan cited G.C.M. 23672, 1943 CUM. BULL. 66:

It is the opinion of this office that the word "home" . . . means the business location, post or station of the taxpayer.

*Id.* at 67. Indeed, the Service reiterated this position in 1960 in Rev. Rul. 60-189, 1960-1 CUM. BULL. 60:

Since 1927, following the decision in *Mort L. Bixler v. Commissioner*, 5 B.T.A. 1181, the location of a taxpayer's "home" for traveling expense purposes in this controversial area has generally been held to be at, or in the vicinity of, his place of business or employment. (Such location is frequently called his post of duty and is at times referred to as his tax or business "home.") The great majority of court decisions considering the meaning of "home" have sustained this interpretation for the reason, among others, that "the statute implies that the home and the place of business must be in the same general locality" and because Congress did not intend "to allow as a business expense those outlays which are not caused by the exigencies of the business but by the action of the taxpayer in having his home, for his own convenience, at a distance from his business." *See Maurice Victor Barnhill et al. v. Commissioner*, 148 Fed. (2d) 913, Ct. D. 1646, C.B. 1945, 96.

*Id.* at 61. The taxpayer also referred to a Second Circuit case, *O'Toole v. Commissioner*, 243 F.2d 302 (2d Cir. 1957), which said that "'(h)ome' as used in the statute means the taxpayer's principal place of business or employment." 243 F.2d at 303. *See also* *Commissioner v. Mooneyhan*, 404 F.2d 522 (6th Cir. 1968); *Haddleton, Travelling Expenses "Away from Home"*, 17 TAX L. REV. 261 (1962); *Note, A House is not a Tax Home*, 49 VA. L. REV. 125 (1963); *Note, Travel Expense Deductions*, 43 VA. L. REV. 59 (1957); *Comment*, 33 S. CAL. L. REV. 307 (1960).

<sup>19</sup> The Commissioner conceded that, in most circumstances, Rosenspan's contention would be correct. However, in this case, the Commissioner asked that home "should be given its natural meaning." 438 F.2d at 907. Support for this suggestion can be found in Justice Douglas' dissenting opinion in *Commissioner v. Stidger*, 386 U.S. 287 (1967): "To me it is clear that home means residence, with the qualification that a taxpayer should establish his residence as near to his place of employment as is reasonable." 386 U.S. at 297. This argument is further strengthened by appreciating that a taxpayer

focused on the intent of Congress in allowing the deduction, *i.e.*, the recognition of a "rational distinction between the taxpayer with a permanent residence — whose travel costs represent a duplication of expense . . . [which] he would not incur absent a business compulsion — and the taxpayer without such a residence."<sup>20</sup> Since Rosenspan did

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who does not maintain his residence near his place of business cannot deduct commutation expenses since such expenses would not meet the "ordinary and necessary" test of section 162. See notes 3 and 11, *supra*. See also *James v. United States*, 308 F.2d 204 (9th Cir. 1962); *Burns v. Gray*, 287 F.2d 698 (6th Cir. 1961).

<sup>20</sup> 438 F.2d at 912. The court rejected the taxpayer's argument that the term "home," meant "business locale," although conceding that "proper analysis of the problem has been beclouded . . . by the Commissioner's (long standing) insistence that 'home' means 'business headquarters.'" *Id.* at 910-11. The Court cited *Flowers v. Commissioner*, 148 F.2d 163 (5th Cir. 1945), *rev'd on other grounds*, 326 U.S. 465 (1946), *Burns v. Gray* 287 F.2d 571 (6th Cir. 1961), *United States v. LeBlanc*, 278 F.2d 571 (5th Cir. 1961), and *James v. United States*, 308 F.2d 204 (9th Cir. 1962), which rejected the "business headquarters" definition.

The court did not, however, categorically affirm the Commissioner's current contention that "home" meant permanent abode. Instead, the opinion took a different approach: the taxpayer was deemed to be a "homeless man," thereby averting the definitional problem. "'(H)ome' means 'home' and Rosenspan had none." 438 F.2d at 912. The Court found it "impossible to read the words 'away from home' out of the statute, as Rosenspan, in effect, would . . . do and allow a deduction to a taxpayer who had no 'home' in the ordinary sense." *Id.* (The court contended that Congress wants the courts to read non-technical words in a way that "ordinary people would understand." *Id.* at 911). Assuming, *arguendo*, that Rosenspan's "business headquarters" was in New York rather than in his sales territory, he still should not be in a better economic position than a travelling salesman who did not have a nexus with any particular locale. *Id.* at 912. The court cited its approval of a disallowance of a travelling expense deduction to a travelling salesman who did not prove a permanent abode in *Duncan v. Commissioner*, 17 B.T.A. 1088 (1929), *aff'd per curiam*, 47 F.2d 1082 (2d Cir. 1931), as well as a more recent Ninth Circuit case, *James v. United States*, 308 F.2d 204 (9th Cir. 1962). In *James*, the taxpayer was an itinerant salesman who travelled constantly, maintaining no residence. The Commissioner's contention that "his home was wherever he happened to be" was sustained by the district court. 176 F. Supp. 270 (D. Nev. 1959). The Ninth Circuit affirmed, 308 F.2d 204 (9th Cir. 1962), basing its decision on the apparent intention of Congress in adopting the provision:

The reason for the selection by Congress of this particular limitation seems fairly clear, and suggests the meaning intended by the phrase as a whole and particularly by the word "home."

[E]xpenditures for meals and lodging can be said to arise from business necessity rather than personal need only to the extent that the taxpayer must pay more for these items as a result of travel for business purposes. And this increased burden can arise either from duplication of from inherently higher cost.

But there is no duplication unless the taxpayer maintains an abode at which he incurs living expenses in addition to those which he incurs while traveling. And when duplication does exist, it constitutes a valid reason for attributing living expenses to business necessity only to the extent of the duplication.

. . . .  
[W]e think the better reasoned authority holds that a taxpayer has a "home" for this purpose only when it appears that he has incurred substantial continuing living expenses at a permanent place of residence.

*Id.* at 207-08. Similarly, deductions have been denied to itinerant workers [Max W. Tugel, 20 CCH Tax Ct. Mem. 693 (1961)], a wandering minstrel [Wilson John Fisher v. Commissioner, 23 T.C. 218 (1954)], and a circus performer [Nat Lewis, 13 CCH Tax Ct. Mem. 1167 (1954)].

not incur this duplication of expenses, he was not entitled to a deduction. It would seem, therefore, that the travelling salesman has been placed in the position wherein it could be to his advantage to establish a permanent abode. The establishment of such a residence would have to be more than just a nominal election of a particular locale,<sup>21</sup> but the cost incurred could conceivably be more than made up by the tax savings which would result from the taxpayer's qualifying for the travelling expense deduction.<sup>22</sup>

The *Rosenspan* decision therefore rested on the interpretation that the court gave to the deduction allowed by section 162 for trade or business travelling expenses. Although the problems raised by attempts to define "home," as used in section 162, have been considerable,<sup>23</sup> a far greater uproar has been evoked in application of its travelling expense provision.<sup>24</sup> In response to the problem, Congress established section 274

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<sup>21</sup> Such is the view of the Internal Revenue Service, evinced in Rev. Rul. 60-16, 1960-1 CUM. BULL. 58, 68. The *James* court also touched on this question, noting that there has been great discrepancies in the cases as to the extent of contact with a particular locality in order to qualify that area as a "home," *James v. United States*, 308 F.2d 204, 206 n.3 (1962). See generally 17 TAX L. REV. 261, 266 (1962); 39 TEXAS L. REV. 922, 927 (1961); 43 VA. L. REV. 59 (1957); 1962 WIS. L. REV. 156.

<sup>22</sup> The questions raised by the decision are numerous. Will renting an apartment in a city establish a "home"? How long must the taxpayer live there? Could he sublease the apartment while gone? The problems inherent in administering such a rule are, therefore, quite apparent.

<sup>23</sup> See notes 18 and 19, *supra*.

<sup>24</sup> The Code does not specifically allow a deduction for entertainment expenditures incurred for a trade or business purpose. Deductions authorized by section 162 for travel expenses have, however, tended to include entertainment expenses. If such expenditures are to be deductible they must meet all the tests governing the deductibility of business expenses. See note 3, *supra*.

Deductions for travel and entertainment expenses (T & E) have long been a thorn in the side of the Internal Revenue Service. Previous to World War II the issues generally raised concerned per diem allowances for travel. See, e.g., Treas. Reg. 33, Arts. 4 and 8 (1937); Treas. Reg. 45, Art. 292 (1937). Following the War the T & E problem mushroomed. Administrative action was instituted. In 1952, Internal Revenue agents were instructed to examine carefully T & E deductions on tax returns in an attempt to curb these items. Bureau of Int. Rev. Rel. No. S-2979 (Feb. 26, 1952). In 1954, under Rev. Rul. 54-195, 1954-1 CUM. BULL. 47, guidelines were established for agents in determining the deductibility of T & E expenses so as to stop abuses. Throughout the 1950's various other administrative attempts were made to stem the increase in T & E deductions. See, e.g., Treas. Reg. 101, Art. 23(a)-2(c) (1950); Treas. Reg. 103 § 19.23(a)-2(c) (1951); Treas. Reg. 111 § 29.23(a)-2(c) (1952); Treas. Reg. 118 § 39.23(a)-2(c) (1953). These administrative attempts did not, however, meet with much success.

Until 1962, attempts to correct the T & E situation legislatively failed as well. In 1951 a subcommittee of the House Ways and Means Committee was appointed to examine the administration of the tax laws. The chairman of the subcommittee, Congressman Cecil G. King, declared that:

(o)ne of the most flagrant sources of inequity and of corruption has been found in the inadequacies of the existing record-keeping requirements and enforcement of these requirements. While the subcommittee will not sanction unreasonable requirements of record-keeping, particularly in the case of millions of small taxpayers, it has become clear from our investigations that under present law exorbitant unsubstantiated deductions have frequently been claimed for such

of the Code as part of the Revenue Act of 1962.<sup>25</sup> Under section 274, travel and entertainment expenses come under extreme scrutiny,<sup>26</sup> and

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items of business expense as entertainment and promotion. Without the power to enforce adequate record-keeping, the Bureau of Internal Revenue has been required to allow such deductions on an estimated basis.

Press release of Congressman Cecil B. King, May 16, 1952, in 39 TAXES 947, 950 (1961). The King Bill, H.R. 7893, 82d Cong., 2d Sess. (1952), was not enacted, however, due to strong business and professional pressure. Further proposals for corrective legislation were made by Senator Clark in the 86th Congress. S. 2040, 86th Cong., 1st Sess. (1959); see also 105 CONG. REC. 11897 (1959). None of these proposals were accepted.

In 1961, therefore, President Kennedy recommended new legislation to deal with the T & E problem. In a special message on our federal tax system, the President recounted the widespread abuses which had developed through the use of the expense account: Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene.

Tighter enforcement of present legislation will not suffice. Even though in some instances entertainment and related expenses have an association with the needs of business, they nevertheless confer substantial tax-free personal benefits to the recipients. In other cases, deductions are obtained by disguising personal expenses as business outlays. But under present law, it is extremely difficult to separate out and disallow such pseudobusiness expenditures. New legislation is needed to deal with the problem.

PRESIDENT KENNEDY'S MESSAGE TO CONGRESS, OUR FEDERAL TAX SYSTEM, H.R. DOC. NO. 140, 87th Cong., 1st Sess. 12-13 (1961).

<sup>25</sup> 76 Stat. 960, 974-77 (1962).

<sup>26</sup> To be deductible, any entertainment activity must fit either of the two categories established by section 274(a)(1)(A). The taxpayer must either establish that (1) the activity was *directly related* to the active conduct of his trade or business or (2) that the activity was *associated with* the active conduct of his trade or business in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or the like). The deduction may not exceed the portion of the expenditure which is directly related to or associated with the active conduct of the taxpayer's trade or business. See S. REP. NO. 1881, 87th Cong., 2d Sess. 29-30 (1961).

The Regulations define "directly related" in detail. If an expenditure is otherwise deductible, it shall be considered directly related to the taxpayer's trade or business if it comes within one of the following categories:

(1) The expenditure is one wherein the taxpayer made or committed himself to the expenditure at a time when he had more than a general expectation of deriving some income or benefit (other than good will) at some indefinite future time; and during the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting or other bona fide business transaction other than entertainment, for the purpose of obtaining income or some other business benefit; and, under the circumstances, the principal character of the combined business and entertainment activity was the active conduct of the taxpayer's trade or business; and that the expenditure was attributable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of his trade or business during the entertainment, or with whom he would have so engaged but for circumstances beyond his control;

(2) The expenditure was directly in furtherance of the taxpayer's trade or business and occurred in a clear business setting;

(3) The expenditure was made directly or indirectly by the taxpayer for the benefit of an individual, other than an employee, and such expenditure represented compensation for services rendered or was paid as a prize or award;

(4) The expenditure was made with respect to a facility used by the taxpayer for furnishing food or beverages in circumstances generally conducive to business discussion, to the extent allocable to the furnishing of such food or beverage.

make it increasingly difficult for personal expenditures to be disguised as business expenses.

Among the provisions of section 274 is the requirement that the taxpayer must substantiate travel or entertainment expenses "by adequate records or by sufficient evidence corroborating his own statement" detailing the amount, time, place and business purpose of each such expense and the taxpayer's business relationship to the persons entertained.<sup>27</sup> Treasury Regulations require a written statement and other corroborating evidence detailing each element of the expenditure if adequate records have not been maintained.<sup>28</sup> In *LaForge v. Commissioner*,<sup>29</sup> the court upheld the taxpayer's contention that the Regulations' demand for a written statement goes beyond the statutory requirement of substantiation by "sufficient evidence corroborating his own statement."<sup>30</sup> LaForge was a surgeon who regularly paid for the lunches eaten in the hospital cafeteria by the residents and interns who assisted him. Although hospital rules prohibited receipts, the cafeteria cashier testified before the Tax Court<sup>31</sup> that the cost of all the meals was between two dollars and sixty-five cents and three dollars a day. No contemporaneous account of these expenditures was maintained. On his tax returns for 1964 and 1965 the surgeon deducted two dollars for each day of his hospital schedule. This deduction was disallowed as not complying with the requirements of the Treasury Regulations.<sup>32</sup> The court rejected the requirement of a written statement and other corroborating evidence establishing each element of the expenditure as set out in the Regulations. To require such substantiation would dismiss from the

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Treas. Reg. § 1.274-2(c) (1969). The Regulations also discuss when an activity is *associated with* the active conduct of the taxpayer's trade or business. See Treas. Reg. § 1.274-2(d) (1969). See also Rev. Rul. 63-144, 1963-2 CUM. BULL. 129.

<sup>27</sup> INT. REV. CODE OF 1954 § 274(d). This section was in response to the great confusion caused by the *Cohan* rule. In *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), George M. Cohan had expended substantial sums in travelling and in entertaining. However, he kept no records of these expenditures. The Commissioner and the Board of Tax Appeals, 11 B.T.A. 743 (1927), refused to allow any deduction, however the Second Circuit remanded the case for "as close an approximation as [can be made], bearing heavily . . . upon the taxpayer." 39 F.2d at 544. Subsequent to *Cohan*, hundreds of cases under which claims for deductions of business expenses on the basis of estimates were decided. Because of the wide area of latitude such a rule permitted, tremendous conflicts arose. See, e.g., *Standard Galvanizing Co. v. Commissioner*, 202 F.2d 736 (7th Cir. 1953); *Estate of Waterman v. Commissioner*, 195 F.2d 244 (2d Cir. 1952); *Durkee v. Commissioner*, 181 F.2d 189 (6th Cir. 1950). See also Rev. Rul. 54-195, 1954-1 CUM. BULL. 47; 18 TAX L. REV. 487, 516 (1962).

<sup>28</sup> Treas. Reg. § 1.274-5(c)(3) (1962).

<sup>29</sup> 434 F.2d 370 (2d Cir. 1970).

<sup>30</sup> INT. REV. CODE OF 1954 § 274(d)(3).

<sup>31</sup> 53 T.C. 41 (1969).

<sup>32</sup> The Commissioner conceded that the substantive requirements of sections 162 and 274 had been met. 434 F.2d at 371.

statute the alternative allowed to the maintenance of "adequate records," *i.e.*, "sufficient evidence corroborating his own statement."<sup>33</sup> Thus, the effect of the current Regulation was to make such corroboration equivalent to "adequate records." The court indicated that it was in the contemplation of Congress that the deduction be substantiated by oral testimony.<sup>34</sup> As the taxpayer was denied an opportunity to prove the maximum cost of his own cafeteria meals as part of his testimonial substantiation, the case was reversed.<sup>35</sup>

A second issue raised in *LaForge* concerned the deductibility of a portion of the surgeon's country club dues as a business expense. Expenditures for entertaining facilities are deductible only if the taxpayer establishes that (a) the facility was used "primarily for the furtherance of the taxpayer's trade or business" and (b) the expenditures were "directly related" to the active conduct of such trade or business.<sup>36</sup> The court reversed the Tax Court's disallowance of the portion of *LaForge's* dues corresponding to the cost of his own meals,<sup>37</sup> citing the Treasury Regulation which permits a deduction of that portion of the dues corresponding to the taxpayer's actual use of the facility for business entertaining.<sup>38</sup> The Regulation quantifies the "directly related" requirement by applying an allocation percentage to the cost of the dues. The percentage is ascertained by determining what portion of the yearly expenditures for food and drink at the club were incurred for business purposes.<sup>39</sup> The Tax Court erred, therefore, in categorically disallowing the cost of the taxpayer's own meals. As the club dues represent the cost of the taxpayer's access to an entertainment facility, and *LaForge's* presence at the meals was a prerequisite to the finding that such meals

<sup>33</sup> INT. REV. CODE OF 1954 § 274(d).

<sup>34</sup> The court cited S. REP. NO. 1881, 87th Cong., 2d Sess. (1962):

(T)he 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.

<sup>35</sup> *LaForge's* own meals were not deductible. The taxpayer must demonstrate that the cost of a business meal exceeded the amount which a non-business meal would have otherwise cost. Richard A. Sutter, 21 T.C. 170 (1953). Although *LaForge* did not prove the cost of his non-business meals, he relied on Rev. Rul. 63-144, 1963-2 CUM. BULL. 129, which indicated that the *Sutter* rule would be applied only in cases of abuse. The proof on remand need only be as to the maximum cost of *LaForge's* cafeteria meals. 434 F.2d at 373 n.3.

<sup>36</sup> INT. REV. CODE OF 1954 § 274(a)(1)(B).

<sup>37</sup> 434 F.2d at 373. Club dues are considered by the statute to be a facility expenditure.

INT. REV. CODE OF 1954 § 274(a)(2)(A).

<sup>38</sup> Treas. Reg. § 1.274-2(c)(6) (1969).

<sup>39</sup> 434 F.2d at 373.

qualified as business entertaining, the cost of his own meals must be directly related to the active conduct of his practice. If such were not the case, the club dues could not qualify as a facility expenditure.<sup>40</sup>

The implications of *LaForge* are clear. Section 274(d) will be understood to provide disjunctive substantiation requirements. If "adequate records" are not maintained, oral testimony coupled with other evidence will provide an alternative proof. A facility expense deduction will be allowed if the taxpayer can quantifiably substantiate the portion directly related to the conduct of his business.<sup>41</sup>

### ALIMONY TAXATION

Section 71(a) of the Internal Revenue Code of 1954 provides that a divorced wife shall include in her gross income a payment, incurred by her former husband under a divorce decree or settlement agreement incident to such a decree, which she receives as one of a series of periodic payments in discharge of the husband's obligation to support his wife.<sup>42</sup> Payments includible in a wife's gross income are deductible by her divorced husband.<sup>43</sup>

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<sup>40</sup> *Id.*

<sup>41</sup> *But see Steel v. Commissioner*, 437 F.2d 71 (2d Cir. 1971), wherein the taxpayer claimed a deduction for the cost of entertaining his clients and other guests in his apartment and the cost of air travel, food, lodging and miscellaneous expenses incurred on trips to New Orleans. No expense account, cancelled checks, receipts or other documentary evidence by which to substantiate the oral claim was maintained. The court upheld the Commissioner's denial of the deduction, distinguishing the case from *LaForge* in that *Steel* offered no evidence whatsoever to corroborate his oral statement. 437 F.2d at 73.

<sup>42</sup> INT. REV. CODE OF 1954 § 71(a). Under section 22(k) of the 1939 Code only the payments attributable to a divorce or legal separation or a written instrument incident thereto were taxed to the wife. To be includible in the wife's gross income, the payment may not be designated by the decree, instrument or agreement as for support of the husband's minor children. Amounts to be divided between wife and children will be applied first to satisfy the children's share in case of an insufficiency. INT. REV. CODE OF 1954 § 71(b). Periodic payments are payments of a fixed amount over an indefinite period or payments of an indefinite amount over a fixed or indefinite period. While section 71 does not define periodic, it provides that installment payments discharging a part of the obligation shall not be treated as periodic. *Id.* § 71(c)(1). However, payments may qualify as periodic if the payment schedule is fixed by decree, instrument or agreement, and it will take more than ten years to discharge the fixed obligation. *Id.* § 71(c)(2). Where the ten-year payment schedule is followed the total sum of payments which may be treated as periodic in any one taxable year of the wife may not exceed ten percent of the fixed sum that such payments are to discharge. *Id.* See *Treas. Reg.* § 1.71-1(d)(2) (1963) as to delinquent payments. Payments may be periodic whether or not they are received at regular intervals. INT. REV. CODE OF 1954 § 71(a). See also *Knowles v. United States*, 290 F.2d 584 (5th Cir. 1961); *Commissioner v. Senter*, 242 F.2d 400 (4th Cir. 1957); *Grant v. Commissioner*, 209 F.2d 430 (2d Cir. 1953); *Bernatschke v. United States*, 364 F.2d 400 (Ct. Cl. 1966).

<sup>43</sup> INT. REV. CODE OF 1954 § 215. The deduction is available only for the year in which payment is actually made. *Treas. Reg.* § 1.215-1(a) (1960). Only the obligor spouse may take the deduction. It is not allowed to any other person who may pay the alimony obligation of such other spouse. *Treas. Reg.* § 1.215-1(b) (1960). The obligor spouse