Business Entertainment Expenses

JAY A. SOLED, LEONARD GOODMAN, AND NATHAN E. ARNELL

The wholesale elimination of business entertainment expenses will not go unchallenged.

For over a century, in some form or fashion, business entertainment expenses have been deductible for income tax purposes. The theory underlying the allowance of such deductions was that such outlays promoted goodwill, which enhanced business growth and generation. As a result, both taxpayers and the government stood to gain: taxpayers enjoyed increased profits; and, by extension, the government obtained augmented tax revenue flow.

However, there were a lot of abuses associated with the deductibility of business entertainment expenses. Taxpayers would orchestrate entertainment events for themselves and their clients that often had little to do with business promotion. Essentially, the government was underwriting taxpayers' fun and games. The IRS routinely challenged the deductibility of such expenses; nevertheless, the agency often lacked the resources to detect taxpayer derelictions.

Over time, Congress had a gradual change of heart. It recognized that, due to taxpayer chicanery and the personal enjoyment component inherent in business entertainment expenses, such expenses should be scrutinized for legitimacy and, furthermore, might not be entirely deductible. That being the case, over the course of time, Congress took several measures: in 1962,[1] it instituted the requirement that all business entertainment expenses had to be substantiated with written documentation.[2] Next, in 1986,[3] it allowed only 80% of such expenses to be deductible.[4] Further,

JAY A. SOLED and LEONARD GOODMAN are tax professors at Rutgers University. NATHAN E. ARNELL is a tax attorney at his own law firm, Law Offices of Nathan E. Arnell, PC.

in 1993,[5] it allowed only 50% of such expenses to be deductible.[6]

The Tax Cuts and Jobs Act (Act)[7] dealt a final death knell to the deductibility of business entertainment expenses. The Act eliminates such deductions in their entirety.[8] Going forward, whatever business entertainment expenses taxpayers incur will not be offset by a corresponding tax deduction. It seems likely, therefore, that many entertainment-oriented industries (e.g., golf and tennis clubs, sporting venues, and the like) will be adversely affected by this dramatic change as taxpayers calibrate their true cost in the absence of tax deductibility.[9]

The wholesale elimination of business entertainment expenses will undoubtedly be challenged. Taxpayers will attempt to recast some or all of such expenditures, in all likelihood, as deductible business promotion expenses and/or meals.

The following section provides an overview of the tax landscape regarding the nature of those expenses, in the aftermath of the Act, that remain deductible. The section after that examines whether, in appropriate situations, business entertainment expenses can meet alternative deductible classifications as business promotion expenses and/or business meals. The next section enumerates the potential penalties and other consequences that taxpayers and their advisers may encounter if met with a successful IRS challenge. The final section offers concluding comments.

Overview of Business Promotion and Meal Expenses

Taxpayers and their advisers are cagey. When it comes to tax savings, if they see one door close, they will often seek to pry another one open. Insofar as the elimination of business entertainment expenses is concerned, this will likely prove to be the case.

At first glance, one obvious and metaphoric door that taxpayers will undoubtedly seek to open is reclassification of some or all of their erstwhile business entertainment expenses as either (A) deductible business promotion expenses or (B) deductible business meals. The contours of each potential deduction are set forth below.

Business Promotion Expenses

Consider traditional business promotion expenses. They fall within the scope of three categories: (i) advertising, (ii) sponsoring activities, and (iii) token gifts and knickknacks. Such expenditures are primarily designed to generate short- and long-term goodwill and, unlike direct business expenses (e.g., the purchase of electricity to operate company machinery), they only indirectly result in future profitability.

Advertising expenditures have long been considered legitimate business expenses and, as such, are fully deductible.[10] Such expenditures help promote business by enticing customers to make purchases and, sometimes, educating them regarding a particular product's virtues. Carefully planned advertising campaigns have launched new products and revolutionized whole industries. Regarding such expenditures, the only controversial item is not if they are deductible but, on occasion, whether such expenses should be capitalized and then amortized.[11]

Sponsoring activities is another avenue that some businesses pursue to cultivate goodwill. Although such activities are not directly related to a taxpayer's trade or business, such expenses are deductible as long as there is a proximate relationship between the activity and the business.[12] For example, deductibility extends to activities such as sponsoring a sporting team or race cars that promote a taxpayer's trade or business.[13]

Beyond advertising and event sponsoring, another means that taxpayers use to expand their business base is to distribute promotional items. A nonexclusive list of business promotional items includes pens embossed with a business name and/or contact information, books displaying expertise in a particular area, and hats or other clothing paraphernalia that portray a business in a favorable light or promote the business's branding campaign. Once again, there is law upholding the deductibility of such expenses.[14]

As evidenced by the billions of dollars that businesses spend annually on items of business promotion, such expenditures apparently yield additional profits (or at least businesses are convinced that they do). Consider that media advertising spending alone in the United States is estimated to be over $218 billion in 2018.[15] Although there is no single dollar figure estimate of how much businesses annually spend on business promotion beyond advertising, the marketing industry continues to flourish, indicating that such expenditures undoubtedly make important contributions to the nation's bustling economy (attributable, in part, to the efforts made by marketing companies and to those businesses distributing promotional material).

NOTES

1 Revenue Act of 1962, P.L. 87-834, 10/16/1962.

2 Section 274(d).

3 Tax Reform Act of 1986, P.L. 99-514, 11/22/1986.

4 Section 274(n).

5 The Omnibus Reconciliation Act of 1993, P.L. 103-66, 8/10/1993.

6 Section 274(n).

7 P.L. 115-97, 12/22/2017.

8 Section 274(a)(1)(A).

9 See, e.g., Ruth Simon, *Season Tickets? Steak Dinners? Small Firms Rethink Client Events After Losing Tax Breaks*, Wall St. J. (May 17, 2018), available at https://www.wsj.com/articles/tax-law-makes-companies-rethink-entertainment-expenses-1526558400.

10 See, e.g., Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising expenses are generally deductible under Section 162 and Reg. 1.162-20(a)(2), "even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising").

11 See, e.g., Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) (advertising costs incurred to allay public opposition to the granting of a license to construct a nuclear power plant required to be capitalized).

12 Gill, TCM 1994-92, aff'd without published opinion, 76 F.3d 378, 77 AFTR2d 96-997 (CA-6, 1996).

13 See, e.g., Strong, TCM 2005-125 (in quest to cultivate business goodwill, expenses incurred in sponsoring a sports team held to be deductible business expense); Hestnes, TCM 1983-727 (taxpayer entitled to deduct costs incurred in sponsoring a race car because taxpayer had the ability to display the company name on the car and race track announcers would periodically refer to the company by name).

14 See, e.g., Ltr. Rul. 8141033 (items such as small appliances, pots, and watches that were distributed to existing and potential customers to open bank savings accounts held to be deductible business promotion expenses).

15 See *Media Advertising Spending in the United States from 2015 to 2021*, available at https://www.statista.com/statistics/272314/advertising-spending-in-the-us/.

Business Meals

In general, prior to the passage of the Act, the Code permitted so-called business meals to be deductible if the meal in question was "directly related to" or "associated with" the taxpayer's trade or business.[16] The Code placed two further limitations on the deductibility of such expenses: (i) such expense could not be "lavish or extravagant under the circumstances," and (ii) the taxpayer had to be present at the furnishing of such meals.[17] This deduction was also limited to 50% of the expense incurred.[18]

After the Act, business meals remain deductible essentially as they were before—that is, subject to the 50% limitation.[19] While Congress seemingly liberalized the deductibility of such rules by eschewing the language requiring that such meals be "directly related to" or "associated with" the taxpayer's trade or business,[20] the Act's legislative history appears to indicate that the pre-Act law remains controlling.[21]

Historically, the deductibility of business meals has been replete with IRS/taxpayer controversy. In some instances, taxpayers lacked the ability to substantiate the amount of the deduction;[22] and in other instances, the IRS asserted that the taxpayer did not have the requisite business purpose for the meal to be deductible.[23]

Notwithstanding the numerous setbacks that taxpayers have endured in their court battles with the IRS, business meal expenses have retained their status as one of the mainstays of tax deductibility. Practitioner journals and the popular press have routinely encouraged taxpayers to maximize their business meal expenditures and, by doing so, correspondingly mitigate their tax burden.[24] In the aftermath of the Act and its disallowance of business entertainment deductions, some taxpayers will undoubtedly test the business meal deduction to determine whether its scope includes an entertainment component.

Reclassification of Business Entertainment Expenses

To minimize their tax burden, taxpayers may seek to reclassify some or all of what are now nondeductible business entertainment expenses as partially or fully deductible. Ideally, if taxpayers can recast such expenses as business promotion expenses, they would be able to secure a dollar-for-dollar deduction. Alternatively, if they can successfully recast such expenses as business meals, they could at least deduct $1 for every $2 they spend.

Having defined what constitutes business promotion and business meals, it is now necessary to define the term "business entertainment." Here, the Treasury regulations are quite broad and instructive. They provide as follows:

"For purposes of this section, the term 'entertainment' means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term 'entertainment' may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family."[25]

In light of this definition, the question that arises is whether taxpayer reclassification efforts will prove fruitful or, alternatively, nonproductive. The next two sections of this analysis indicate that despite taxpayer efforts to the contrary, the bulk of their reclassification efforts is apt to prove ineffectual.[26]

Business Entertainment Not Equal to Business Promotion

Even prior to the Act's passage, to avoid the 50% deduction limitation associated with a business meals expense, taxpayers often characterized expenses as fully deductible promotional expenses. In general, taxpayers litigating this issue with the IRS did not fare well.

Consider one emblematic case, *Churchill Downs, Inc.*[27] In *Churchill Downs*, the taxpayer operated several racetracks and hosted the Kentucky Derby. In connection with the race, the taxpayer sponsored several events, including a gala (comprised of a press reception/cocktail party, dinner, and entertainment), a brunch, a weeklong hospitality event, and a winner's party. In addition, the taxpayer also hosted the Breeder's Cup, which included a press reception cocktail party and dinner, a brunch, and a press breakfast.

On its tax return, the taxpayer deducted the entirety of such expenditures, categorizing them as "ordinary and necessary" business expenses under Section 162. On audit, the IRS rejected this classification, labeling such expenses instead as being a horse of a different color—they were in the nature of business entertainment and, as such, subject to the 50% deduction limitation.

The Tax Court held in favor of the Commissioner's position. On appeal, the Sixth Circuit affirmed. It primarily relied upon what practitioners commonly refer to as the "objective test" promulgated under the Treasury Regulations,[28] which, in part, provide as follows:

"An objective test shall be used to determine whether an activity is of a type

NOTES

16 Section 274(a)(1)(A).

17 Section 274(k).

18 Section 274(n).

19 *Id.*

20 Section 274(a)(1)(A).

21 H. Rep't No. 115-466, 115th Cong., 1st Sess. 407 (2017) (Conference Report) ("Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel).").

22 See, e.g., Strong, TCM 1997-105 (taxpayer denied meal expense deductions insofar as restaurant check stubs alone did not constitute adequate substantiation).

23 See, e.g., Bigdeli, TCM 2013-148 (oral surgeon could not prove that the cost of his meals was business related, and, consequently, deductibility was denied).

24 See, e.g., *How to Maximize Your Meal Tax Deductions* (2018), available at https://quickbooks.intuit.com/r/taxes/how-to-maximize-your-meals-and-entertainment-tax-deductions/.

25 Reg. 1.274-2(b)(1).

26 Nevertheless, due to the IRS's limited resources, the agency's ability to police taxpayer compliance may prove lackluster.

27 307 F.3d 423, 90 AFTR2d 2002-6615 (CA-6, 2002).

28 Reg. 1.274-2(b)(1)(ii).

generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and section 274(a) *regardless of whether the expenditure can also be described otherwise*, and even though the expenditure relates to the taxpayer alone. *This objective test precludes arguments such as that 'entertainment' means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations.* (Emphasis added.)"[29]

Regarding the events that the taxpayer hosted, the taxpayer's product (namely, horses) was not present. In addition, at several of these events, the taxpayer's paying customers were not invited. The real reason for these gatherings was truly social in nature as attendees enjoyed the spectacle of these events and hobnobbing with one another. As the Commissioner articulated and the court quoted, "taxpayers were in the horse racing business, not the business of throwing parties."

With respect to the *Churchill Downs* case, while there are many takeaways, two stand out. First, entertainment expenses are those that lead to people being amused (e.g., a show, theatrical event, or sporting spectacle) or enjoying themselves (e.g., a party, meet-and-greet reception, or recreational event).[30] The fact that a taxpayer is also promoting its trade or business is truly secondary to the taxpayer's quest to generate customer goodwill.[31] Second, had the taxpayer been properly advised and invited existing and potential customers to the events and, furthermore, dedicated at least a meaningful segment of the various presentations and exhibitions toward educating viewers about the trials and tribulations of horse racing, then the associated expenses might have been deductible.[32]

Business Entertainment Not Equal to Business Meals

Unable to recast the mainstay of their business entertainment expenses as deductible items of business promotion, taxpayers will likely consider alternative paths to securing a deduction. Under the theory that half a loaf is better than none, such taxpayers may attempt to categorize their business entertainment expenses as deductible business meals, subject to the 50% limitation.[33]

Consider two different scenarios. In scenario 1, the taxpayer wishes to meet a client to discuss the sale of goods, have dinner, and see a show. The taxpayer takes a $50 Uber ride from her office to the theater venue, has a $100 dinner with the client at a conveniently located restaurant, and then sees a $200 show ($100 cost per ticket). The taxpayer would like to treat the entire $50 Uber ride as fully deductible and amalgamate the remaining $300 of expenses (i.e., $100 dinner and $200 show costs) as deductible, subject to the 50% limitation. Due to the Code's substantiation requirements,[34] however, which would require that each component of these expenses be identified, there is no doubt that, if audited under current law, the IRS would disallow the deductibility of the theater tickets.

In scenario 2, suppose the same events unfold. This time, however, suppose the taxpayer and customer attend dinner, which includes a theatrical show that is part of the purchase price (with a fixed price menu and a total bill of $300). In this case, the receipt will indicate that the $300 price was for dinner and will probably not indicate that a show was included. While it's impossible to know with certainty, even if the taxpayer were audited, the IRS would probably permit this expense to be deducted, subject to the 50% limitation.[35]

In light of these two different scenarios and their probable outcomes, it is likely, going forward, that food vendors and theatrical companies will join forces to offer meals that include show entry (at the same physical location).[36] In years past, in accordance with the Code, the IRS tried to limit the deductibility of business meals that the agency deemed abusive.[37] In light of these prior decisions, when the price (which includes both a meal and a show) is reasonable (i.e., within the bounds of what a meal might normally cost, albeit at its upper bounds), the IRS will probably permit deductibility.[38] Conversely, if the price is extraordinary (i.e., if it is extravagant), the IRS will likely disallow the entire expense.[39]

Disallowed Business Entertainment Expenses and Their Consequences

As previously indicated, taxpayers may arrange their business affairs in strategic ways that enable them to treat some of their business entertainment expenses as deductible. Deductibility of any form of business entertainment expenses, however, will be the exception (and will likely be ancillary in nature). In the vast majority of cases, such expenses will not be deductible.

With the assistance of their advisers, taxpayers may nevertheless attempt to deduct business entertainment expenses, embracing tax return positions that are devoid of substantial authority. In those instances, additional taxes, interest, and penalties may be owed. The following section explores these consequences from the taxpayer's perspective, and the section after that does the same but from a tax return preparer's vantage point.

NOTES

[29] Originally promulgated in 1963, these Treasury regulations have been routinely deferred to by the courts. Mayo Foundation for Medical Ed. & Research v. U.S., 562 U.S. 44, 107 AFTR2d 2011-341 (2011).

[30] Reg. 1.274-2(b)(1)(i).

[31] See, e.g., Andress, 51 TC 863 (1969) (practicing attorney claimed deductions related to hosting social events at his home were "courtesy and promotion expenditures" but were clearly entertainment in nature, and, that being the case, the taxpayer's efforts to argue to the contrary were mere "indulging in semantics.")

[32] Churchill Downs, *supra* note 27. See also Reg. 1.274-2(b)(1)(ii) (the expenses incurred by a dress manufacturer who hosts a fashion show for potential customers to introduce a new line of products are deductible as promotional expenses and should not be classified as business entertainment expenses).

[33] Section 274(n).

[34] Section 274(d).

[35] Section 274(n).

[36] By way of example, many Japanese hibachi restaurants combine dinner with a "show" with respect to the way the meal is prepared.

[37] See *supra* note 23 and accompanying text.

[38] Subject, of course, to the 50% limitation. Section 274(n).

[39] Section 274(k)(1)(A).

Mischaracterization and Its Consequences to Taxpayers

In order to save tax dollars, taxpayers sometime take measures that do not always comport with Code tenets. In light of the new law, and under the theory that old habits are hard to break, some taxpayers will undoubtedly mischaracterize their business entertainment expenses as deductible. When they do, they risk a battery of potential consequences.

One direct consequence is that taxpayers are apt to owe the underpaid tax associated with the disallowed deduction plus concomitant interest on such unpaid tax for the time period of the delinquency.[40]

The harder determination to make is whether taxpayers risk penalty exposure by deducting their business entertainment expenses. Since the Code now strictly prohibits business entertainment expenses from being deducted, those taxpayers who take such deductions risk the IRS deeming such tax return positions as negligent or reckless, triggering application of the Code's accuracy-related penalty.[41] Taxpayers can only defeat this penalty if they have reasonable cause.[42] Reliance on their tax adviser alone is often insufficient to negate penalty application.[43]

As time progresses and the non-deductibility of business entertainment expenses becomes more ingrained and more deeply woven into the Code's fabric, the IRS will probably exhibit decreasing leniency. More specifically, those taxpayers who continue to deduct business entertainment expenses may encounter graver risks. In particular, taxpayers who take such deductions (which are now essentially tantamount to nondeductible personal expenses),[44] may risk exposure to the civil fraud penalty[45] and, in extraordinary cases, perhaps even criminal exposure.[46]

Mischaracterization and Its Consequences to Tax Adviser

Tax return preparers cannot render unsubstantiated tax advice. To the contrary, the advice they render must be grounded in substantial authority;[47] or, alternatively, if such authority is lacking, they must advise their clients to take positions that have a reasonable basis accompanied by the filing of a disclosure statement.[48]

Tax return preparers who proffer advice that runs afoul of these Code requirements risk penalty exposure. The penalty amount is equal to the greater of (i) $1,000 or (ii) 50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.[49] In those cases where the tax return preparer's conduct rises to the level of willful or reckless conduct—a distinct possibility in those cases when a tax return preparer endorses the deductibility of entertainment expenses—the Code raises the penalty to the greater of (i) $5,000 or (ii) 75% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.[50]

Beyond the financial penalties the Code imposes, there are two other concerns that all tax return preparers must consider. First, if the tax return preparer regularly and consistently prepares tax returns that deduct business entertainment expenses, the IRS may refer the tax return preparer to the Office of Professional Responsibility (OPR).[51] The OPR would then be charged to determine if the tax return preparer's derelictions constitute a Circular 230 violation and, if so, the appropriate penalty (i.e., censure, suspension, disbarment, or imposition of a monetary penalty).[52]

A second and more likely concern that most tax return preparers harbor is that if the IRS successfully challenges a tax return they prepare, they risk the client suing them for professional malpractice. Taxpayers will often contend that if they had received the proper advice, they would not have taken particular tax return positions; and, as such, the fault of such flawed positions lies with the tax return preparer. In a malpractice lawsuit, if taxpayers can prove causation, they can often recover interest, penalties, legal fees, and other possible monetary damages.[53]

Conclusion

Since Congress instituted the income tax, business entertainment expenses have been considered deductible in some form or fashion. Over this same period of time, taxpayers have become accustomed to enjoying various forms of business entertainment and having the government, in part, subsidize these expenditures.

With the Act's passage, however, over a century of law has been cast aside. As a result, taxpayers will no longer be able to deduct any portion of their business entertainment expenses. Nevertheless, many taxpayers will seek to categorize at least some or all of their business entertainment as business promotion or business meals, thus making such expenses fully or partially deductible. As taxpayers engage in this categorization process, however, they should be circumspect: in those instances where the IRS deems such reporting practices to be too aggressive, the agency can and likely will penalize taxpayers and, depending on the circumstances, their advisers. ●

NOTES

[40] Section 6601.

[41] Section 6662(a).

[42] Section 6664(c).

[43] See, e.g., Long-Term Capital Holdings v. U.S., 330 F. Supp. 2d. 122, 94 AFTR2d 2004-5666 (DC Conn., 2004), aff'd, 150 F. App'x 40 (CA-2, 2005) (reliance placed on tax professional advice did not shelter taxpayer from penalties when the advice was premised upon false assumptions).

[44] Section 262(a).

[45] Section 6663(a).

[46] Section 7201.

[47] Section 6694(a)(2)(A).

[48] Section 6694(a)(2)(B).

[49] Section 6694(a)(1)(B).

[50] Section 6694(b)(1).

[51] Circular 230 § 10.53(a).

[52] Id., § 10.50.

[53] For an excellent overview of this area of the law, see generally Joseph L. Todres, *Tax Malpractice: Areas in which It Occurs and the Measure of Damages—An Update*, 78 St. John's L. Rev. 1011 (2004).