Elimination of the Deduction for Business Entertainment Expenses

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This proposal would deny deductions for all business entertainment expenses. Also, the definition of the term ''entertainment'' would be narrowed so that expenses that are incurred in a clear business setting and are deeply rooted in producing immediate income or in mining future income prospects (for example, a hospitality tent) would remain deductible. Finally, as part of our proposal, taxpayers who continue to deduct business entertainment expenses would be exposed to an accuracy-related penalty. We anticipate that the adoption of this proposal would raise significant revenue.

The proposal is offered as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue without raising tax rates because the best systems have taxes that are unavoidable to reach the lowest feasible tax rates. Shelf Project proposals defend the tax base and improve the rationality and efficiency of the tax system. Given the calls for economic stimulus, some proposals may stay on the shelf for a while. A longer description of the Shelf Project is found at ''The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

A. Overview

Business entertainment expenses have been deductible since the inception of the nation's revenue laws.[1] That was done not by specific design, but rather because the taxpayers who incur those expenditures routinely judge them as ordinary and necessary business outlays satisfying the statutory requisites for deductibility.[2] Nevertheless, over the ensuing decades, Congress has incorporated in the code a series of limitations and monitoring devices to curb perceived taxpayer abuses of this deduction.[3]

But those limitations and monitoring devices have missed their intended target. Because business entertainment has a substantial personal consumption element, its deduction as a business expense is inevitably dubious as a conceptual matter. Also, the business nexus claimed to justify the expense cannot, as a practical matter, be adequately policed by the IRS. The deduction raises concerns about fairness and taxpayer morale because the financial benefits resulting from the deductibility of those expenses inure disproportionately to the wealthy and powerful. Finally, business entertainment expenditures are often incurred in an implicit effort to subvert the rational economic decision-making of the party being entertained — an effect that is both economically inefficient and morally corrosive.

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[1] *See, e.g.*, Corporation Tax Act of August 5, 1909, 36 Stat. 11, 112, ch. 6, section 38 (the law specifically permitted corporations, in computing their net income, to deduct their ''ordinary and necessary'' expenses). The deductibility of business entertainment expenses probably first came to national prominence in the early 1920s in a case involving the lavish expenses incurred by theatrical producer George M. Cohan (lyricist for such classics as ''Yankee Doodle Dandy'' and ''You're a Grand Old Flag''). In an opinion written by Judge Learned Hand, the Second Circuit decided that because it was clear that Cohan had incurred some expenses, the deduction could not be wholly denied simply because there was no documentation of the expenses. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

[2] For early examples of how the courts approached the deductibility of business entertainment expenses, see *Blitzer v. Commissioner*, 3 B.T.A. 696 (1926) (''considerable entertainment expenses'' were held deductible because they constituted ''ordinary and necessary business expenses''); *McQuade v. Commissioner*, 4 B.T.A. 837, 840 (1926). (''In light of the evidence, we are of the opinion that the amount spent for the purchase of such tickets constituted an ordinary and necessary expense of the taxpayer in the conduct of his liquor business and as such was deductible from gross income.'')

[3] *See generally* Michel G. Emmanuel and Norman H. Lipoff, ''Travel and Entertainment: The New World of Section 274,'' 18 *Tax L. Rev*. 487 (1962-1963).

B. Current Law

Ordinary and necessary business expenses are generally deductible,[4] whereas personal consumption expenses are not.[5] Under current law an entertainment event, such as attendance at a professional sports event, can constitute a deductible business expense rather than an item of personal consumption if the expenditure is business-oriented and it is ordinary and necessary in nature.[6] However, the deductibility of entertainment expenses is subject to a gauntlet of special rules found in section 274(a), (d), and (n).[7] Congress added those special rules to ensure that the expenditures had a genuine business nexus (section 274(a)), to facilitate the IRS's ability to monitor compliance (section 274(d)), and to reflect the mixed motives — business promotion and personal consumption — underlying the expenditures (section 274(n)).[8]

Section 274(a) sets forth criteria that must be met before entertainment expenses become deductible. It provides that entertainment expenses are generally not deductible unless the entertainment is ''directly related to'' or ''associated with'' the active conduct of the taxpayer's trade or business. Regulations under section 274 amplify the meaning of the quoted phrases.

To satisfy the ''directly related'' test under the general rule, the following four conditions must be met: First, the taxpayer must clearly have the realistic expectation of making a future profit as a result of incurring the expenditure.[9] Second, the event must include an actual business meeting, negotiation, discussion, or other bona fide business transaction for the purpose of obtaining income or another specific trade or business benefit.[10] Third, in light of all the circumstances, the principal purpose of the activity must be business, not entertainment.[11] Finally, nonbusiness guests (other than spouses) should not be present during the event.[12]

The application of the directly related test is illustrated by *United Title Insurance Co. v. Commissioner*, a case in which the Tax Court allowed a title insurance company to deduct the resort expenses it incurred to host business-generating seminars and business meetings for its board members and unrelated real estate professionals.[13] The directly related test can be met under an alternative to the general rule if expenditures are made for entertainment in a clear business setting, a place where clients would reasonably know that the taxpayer had no significant motive for incurring the expenses other than directly to further its trade or business.[14] The regulations cite several examples of clear business settings, including the sponsorship of a hospitality room at a business convention.[15]

The regulations also amplify the meaning of the ''associated'' test. Under that test, the taxpayer must satisfy both of the following conditions: First, the taxpayer must show that the entertainment expenditure was business-motivated.[16] Second, ''substantial and bona fide'' business discussions must directly precede or follow the entertainment event.[17] The regulations add that the taxpayer must establish that ''such a business meeting, negotiation, discussion, or transaction was substantial in relation to the entertainment.''[18] The committee report that accompanied the passage of section 274 offers an example of an associated entertainment expense: A taxpayer engages in substantial business negotiations with a group of business associates and later in the day entertains the business associates and their spouses at a theatrical event. The entertainment expenses are deductible under the associated test even though their underlying purpose was to generate goodwill.[19]

Aside from having to meet the directly related or associated tests, taxpayers are required by section 274(d) to substantiate the deductibility of their expenses. That rule supplants the so-called *Cohan* rule, which had generally allowed taxpayers to use estimates in the absence of documentation to authenticate deductible business expenses.[20] The regulations elaborate on the items a taxpayer must provide for a business entertainment expense to be deductible. For entertainment expenses that meet the directly related test, the taxpayer must provide the amount of the expense, the time and place that the entertainment transpired, the business purpose of the meeting, and the business relationship of the attendees.[21] For entertainment expenses that meet the associated test, the taxpayer must additionally provide the time and place of the business activity and supply information regarding the business purpose of the discussion and the business relationship of those who participated in that discussion.[22]

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[4]Section 162(a).

[5]Section 262.

[6]*See, e.g.*, *Churchill Downs Inc. et al. v. Commissioner*, 115 T.C. 279 (2000), *Doc 2000-24768*, *2000 TNT 188-9* (entertainment expenses incurred in hosting invitation-only events at the Kentucky Derby were ''ordinary and necessary'' in nature and thus deductible, subject to the limitations of section 274).

[7]For an overview of deductible entertainment expenses and the limitations found in section 274, see IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*.

[8]*See* H.R. Rep. No. 111, 103d Cong., 1st Sess. 645 (1993): ''Some portion of business meal and entertainment expenses represent personal consumption (even if the expenses serve a legitimate business purpose).''

[9]Reg. section 1.274-2(c)(3)(i).

[10]Reg. section 1.274-2(c)(3)(ii).

[11]Reg. section 1.274-2(c)(3)(iii).

[12]Reg. section 1.274-2(c)(3)(iv).

[13]*United Title Ins. Co. Inc. v. Commissioner*, T.C. Memo. 1988-36.

[14]Reg. section 1.274-2(c)(4).

[15]*Id.*

[16]Reg. section 1.274-2(d)(2).

[17]Reg. section 1.274-2(d)(3).

[18]*Id.*

[19]H.R. Rep. No. 2508, at 17 (1962) (Conf. Rep.), 1962-3 C.B. 1144; S. Rep. No. 1881, at 29 (1962), 1962-3 C.B. 735.

[20]*See generally* Jay A. Soled, ''Exploring and (Re)defining the Boundaries of the *Cohan* Rule,'' 79 *Temple L. Rev*. 939 (2006). *See also supra* note 1 for a description of the *Cohan* decision.

[21]Reg. section 1.274-5T(b)(3).

[22]Reg. section 1.274-5T(b)(4).

Section 274(n) is the final barrier along the section 274 gauntlet. That section currently limits the deductible entertainment expense amount to 50 percent of the expenditure incurred. Congress added the provision in the Tax Reform Act of 1986 (in the milder form of a 20 percent disallowance),[23] largely in recognition of the substantial consumption activity involved in business entertainment. In 1993 the disallowance percentage was increased to the current level of 50 percent.[24]

C. Reasons for Change

On several different grounds, business entertainment expenses should not be deductible: (1) because of the substantial personal consumption involved in business entertainment, the deductions lack a solid theoretical justification; (2) the IRS lacks the resources and ability to police the legitimacy of those deductions; (3) the benefits of the deductions inure disproportionately to the wealthy[25]; and (4) the deductions encourage business practices that are intended to subvert optimal decision-making by the taxpayer's clients and customers, which is both inefficient and morally corrosive.[26]

1. Lack of theoretical justification for deductibility. The deductibility of business expenses is predicated on the notion that the dollars so expended cannot be used for personal consumption.[27] Business entertainment expense deductions are at odds with that notion because both the taxpayer and the prospective or existing client partake of personal consumption via the entertainment event.

For example, in the case of a nonbusiness purchase of a $500 ticket to an entertainment event, the purchaser may be presumed to expect at least as much utility from attending the event as he would from retaining the $500 for other uses; otherwise, he wouldn't make the purchase. It might be argued that this presumption would not apply in a case of forced or constrained consumption, which may sometimes be the situation in business entertainment. Both the host and the guest in a business entertainment situation may attach a lesser value to tickets they use, for a variety of reasons, but they proceed with the entertainment expenditure anyway. In each individual business entertainment case, it might therefore be theoretically possible to estimate some lower value for the consumption of each ticket. But it is not possible to administer a tax system that requires an army of economists and psychologists to estimate the price each party would have paid in an unconstrained purchase.

In most situations, despite possible doubts about whether a taxpayer enjoyed full value, the underlying tax rules insist that the fair market value of the expenditure be imputed into income as the measure of the consumption. That is the basic rule that applies to property received in kind as compensation for services (for example, a one-year-old plasma television set paid to a landscaper to cut down a tree),[28] even when there may be substantial doubt about the true value of what is received.[29] Similarly, the regulations on employee fringe benefits explain that "an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value."[30]

The rule in the business entertainment context has historically differed from the applicable rules in compensation or employment situations, but not for any sound reason. For many years, the consumption value of business entertainment was simply ignored. Neither the host nor the guest was considered to receive income as a result of consuming valuable entertainment, and the host was allowed to deduct the entire cost incurred. Recognizing the personal consumption involved in those situations, Congress added subsection (n) to section 274 in 1986, partially denying the host's deduction of business entertainment expenses.[31] As amended in 1993, the provision now denies deduction of 50 percent of the expenditure.[32] That is best seen as an example of surrogate taxation:

[23]P.L. 99-514, section 142 (1986).

[24]Revenue Reconciliation Act of 1993, which was part of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, section 13209(a).

[25]We would not regard this disproportion as necessarily objectionable in all cases; however, in view of the other problems with deducting business entertainment expenditures, these unfortunate distributional consequences seem worth noting as an aggravating factor.

[26]Before elaborating on these arguments, we note one important limitation in the scope of our proposal. Although many of the foregoing concerns apply equally to both business entertainment and business meals, we confine our recommendations here to only business entertainment. That is because we regard business entertainment as inherently problematic but believe that business meal deductions, in contrast, may sometimes involve abuse but are often legitimate. If, for example, a contract negotiation were to last an entire working day, it would certainly be expected that lunch would be consumed at some point in the middle of that day. Although the lunch would have some elements of personal consumption, it is likely that a catered lunch brought into a downtown boardroom would be substantially more costly than a lunch of equivalent nutritional and culinary value purchased in another context. Accordingly, the rules allowing half the cost of that lunch to be deducted seem to us reasonably accurate and sensible.

[27]Deductions for business expenses are predicated on the principle that taxpayers who incur expenses to produce income should be taxed on a net, rather than a gross, basis. *See, e.g.*, *Hantzis v. Commissioner*, 638 F.2d 248, 249 (1st Cir. 1981). (A "fundamental principle of taxation is that a person's taxable income should not include the cost of producing that income.")

[28]Reg. section 1.61-2(d)(1).

[29]*See, e.g.*, *Rooney v. Commissioner*, 88 T.C. 523 (1987), in which the taxpayer was an accounting firm that allowed distressed business clients to pay for accounting services in kind. A "cross accounting" was employed, by which the members of the accounting firm could charge goods and services provided for their personal use against the accounting fees owed by the providers of those goods and services. The value of the goods and services consumed by the members of the accounting firm were taken into income, but at discounts ranging from 17 percent to 50 percent of their market value. The IRS, and ultimately the Tax Court, denied the discounts and insisted on inclusion of the market value of what was consumed, reasoning that an objective standard was required under section 61.

[30]Reg. section 1.61-21(b)(2).

[31]*See supra* note 23.

[32]*See supra* note 24.

Although the ideal treatment of the expenditure might be to require inclusion of the value of the entertainment in the income of both the individual host and the guest, it is more practical, and achieves roughly the same aggregate increase in taxable income, to deny the deduction of the expense by the host business.[33] Because the expenditure is only half denied, section 274(n) is also an example of what might be called Solomonic justice. But a Solomonic approach has no justification in a tax system that ordinarily requires inclusion, at full market value, of goods and services received in kind.[34]

The reasoning that supports the FMV inclusion rule in the employment context also supports a full denial of deductions for business entertainment expenses. The reasoning is essentially that it is not in an employer's interest to shower its employees with costly goods and services that the employees do not substantially value. Similarly, it is not in the interest of a seller of goods or a provider of services to shower potential customers or clients (as well as its own employees) with entertainment opportunities that are not substantially valued by the recipients of those benefits.

The taxpayer who sponsors the entertainment event can choose an event that it expects its employees and potential clients and customers will prefer. If the firm thinks its manager, clients, and customers are football fans, it will purchase box seats for a football game rather than another event. By the same token, clients can be selective in the entertainment events they choose to attend, declining events in which they have no interest and avoiding the social company of individuals they may dislike. In light of their ability to select entertainment events that they are likely to find pleasurable, most taxpayers and clients probably derive economic utility close to or equal to the full ticket value, on par with attendees who are at the event for a nonbusiness purpose.

All of this is very familiar ground to tax theorists. However, under section 274(n), those who purchase and consume business entertainment do so under tax-favored conditions. Consider the benefits that inure to purchasers of business entertainment and then the benefits to those who consume it. When a seller of goods purchases two front-row, $500 tickets to an entertainment event, one for its own sales manager and the other for the purchasing agent of a potential customer, it does so at a net cost of $825 — the gross cost of $1,000, less the tax reduction achieved by deducting half of that amount taken against a 35 percent tax rate.[35] By contrast, if the potential seller and buyer wished to compensate their respective agents by an incremental $500 each, the total cost of doing so would be the full $1,000.[36] The ticket recipients are also beneficiaries of this arrangement because each experienced a $500 benefit that otherwise would have required them to have earned $769 in incremental gross wages.[37] Instead, each had a $0 cash outlay, despite the economic utility each experienced.

Deductions for expenditures are appropriate only in the absence of personal consumption; when consumption predominates, deductions that offset taxable income are inappropriate.[38] An alternative to denial of the deduction would be to include the consumption value of business entertainment in the income of those who actually consume it. But that is likely to be terribly impractical. No businessperson would be inclined to issue a Form 1099 to each prospective or existing client in attendance (nor would an employer be inclined to increase the amount shown as compensation on an entertained employee's Form W-2). Denying the deductibility of business entertainment expenses in their entirety achieves the same end in a more reasonable way.

2. Inability to administer the deductibility of business entertainment expenses. The famous *Cohan* case[39] was the genesis of the rule bearing its name. The *Cohan* rule posited that taxpayers who lacked documentation of business expenses were at liberty to claim deductions based on reasonable estimates. In years past, taxpayers aggressively used the *Cohan* rule to claim deductions for business entertainment expenses. If the IRS challenged the legitimacy of those deductions, taxpayers would negotiate a settlement with the IRS based on estimates.[40] Section 274(d) was designed to eliminate that practice. If taxpayers deducted entertainment expenses, the burden was henceforth on them to produce documentation that substantiated the deductible nature and amount of the expenses that they incurred.[41] It was hoped that this tool given to the IRS by Congress in section 274(d) would substantially control bogus and undocumented entertainment expenses.

Despite the substantiation requirements of section 274(d), however, taxpayers continue to take aggressive

[33]That was, in fact, the explicit reasoning underlying section 274(n): "Denial of some part of the [deduction for business meals and entertainment] is appropriate as a proxy for income inclusion of the consumption element of the meal or entertainment." H.R. Rep. No. 111, 103d Cong., 1st Sess. 645 (1993).

[34]It may be useful to recall that King Solomon never really intended to split the baby; he simply wanted to test which of the two putative mothers held the baby in higher regard.

[35]That is, a deduction of $500 saves a 35 percent bracket taxpayer $175, which reduces the net cost of the entertainment by that amount.

[36]Buyers and sellers of goods and services may also engage in a pas de deux whereby one purchases the business entertainment for one event and the other reciprocates by hosting another event, in a cycle that can be endlessly repeated.

[37]$769 in incremental gross wages less $269 in taxes ($769 x 35 percent) nets $500.

[38]*See generally* Henry C. Simons, *Personal Income Taxation* (1938), at 51: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."

[39]*See supra* note 1.

[40]Mortimer M. Caplin, "The Travel and Entertainment Expense Problem," 39 *Taxes* 947 (Dec. 1961); Reinhold Groh, "Travel and Entertainment Expenses," 39 *Taxes* 253 (1961); John S. Perkins, "Recommendations for Preventing Disallowance of Expenses for Travel and Entertainment," 4 *J. Tax'n* 10 (1956); Malcolm Reed, "Uncle Sam v. Expense Account," 39 *Taxes* 329 (1961).

[41]*See generally* Emmanuel and Lipoff, *supra* note 3.

return positions on business entertainment. That aggressiveness is evident in the substantial number of court cases in which this issue has been litigated.[42] There are several reasons, elaborated below, why section 274(d) has proven largely ineffectual.

One of the primary reasons for section 274(d)'s impotence is distressingly familiar: The IRS is not adequately funded.[43] It is unable to conduct enough audits,[44] and the audits it does conduct are not sufficiently thorough.[45] Thus, taxpayers who take aggressive return positions regarding the deductibility of their entertainment expenses rarely meet with any resistance, and the challenges they do meet are halfhearted.

But a deeper reason for rampant noncompliance in this area is conceptual: Business entertainment expenses simply do not lend themselves to easy verification. Although the details of date, place, and amount are concrete enough, the most crucial question — the relationship of the expenditure to the legitimate advancement of the taxpayer's business — is inherently elusive. Indeed, it appears that in practice, taxpayers hardly bother to provide any real documentation of business purpose. If a taxpayer incurs an entertainment expense, the ''documentation'' an IRS agent is likely to receive is a receipt with a client's name in pencil or pen scrawled across it with a note such as ''re: discussed business.''[46] Although those receipts may not technically satisfy the detailed criteria set forth in the regulations,[47] anecdotal evidence suggests that IRS agents ordinarily accept less-than-perfect documentation.[48] If the agent attempts to authenticate the legitimacy of an entertainment expense by questioning the client who benefited from the taxpayer's largesse, the client will likely support the taxpayer's claims regarding the business nature of the event.[49] And, clearly, it is in the nature of business entertainment that no disinterested third party is on the scene to verify the business nature of the event.

There's a final reason that compliance concerning the deductibility of entertainment expenses is so lackluster. Simply put, on a case-by-case basis, the monetary amounts involved in deductible entertainment expenses are usually small relative to other deduction items. Those small deduction amounts foster the mentality that being aggressive in deducting business entertainment expenses will be strategically successful in either of two ways. If the taxpayer is not audited, it will be able to secure tax savings. Alternatively, if the taxpayer *is* audited, the business entertainment deductions will divert the IRS agent's attention from possibly more significant and questionable deductions. With little downside risk, for the last several decades this approach has been quietly endorsed by tax practitioners and widely adopted by business taxpayers.

A few examples drawn from the Tax Court docket in recent years illustrate the type of aggressive taxpayer behavior described above:

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[42]*See, e.g.*, ''National Taxpayer Advocate's 2008 Annual Report to Congress,'' pp. 500-505 (2008), *Doc 2009-241, 2009 TNT 4-21*. (This report, issued annually, commonly lists the deductibility of entertainment expenses and their substantiation as one of the most commonly litigated taxpayer items.)

[43]*See, e.g.*, OMB Watch, *Bridging the Tax Gap: The Case for Increasing the IRS Budget* 5 (2009), *available at* http://www.ombwatch.org/budget/irstaxgap2008.pdf (''Charles Rossotti, former Commissioner at the IRS, told the IRS Oversight Board in 2002 that much of the tax gap is a result of the failure of Congress to provide enough resources for tax law administration.''); Michael Brostek, ''Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap,'' GAO-07-391T, at 16 (Feb. 2007), *Doc 2007-1834*, *2007 TNT 16-59* (''Given resource restraints, the IRS is unable to contact millions of additional taxpayers for whom it has evidence of potential noncompliance.''); and Statement of Robert S. McIntyre Before the Senate Budget Committee (Jan. 23, 2007), *Doc 2007-1835, 2007 TNT 16-60*. (''So the most essential step [to close the tax gap] that needs to be taken is simply to give the IRS more resources.'')

[44]*See* Government Accountability Office, *Internal Revenue Service: Assessment of the Fiscal Year 2006 Budget Request* 11 (2005) (IRS audit rates declined steeply from 1995 to 1999, but the audit rate has slowly increased since 2000); GAO, ''IRS Audit Rates: Rate for Individual Taxpayers Has Declined but Effect Upon Compliance Is Unknown,'' GAO-01-484 (Apr. 2001), *Doc 2001-14957*, *2001 TNT 105-31* (depicting the small number of annual audits that the IRS conducts on individual income tax returns).

[45]*See, e.g.*, David Cay Johnston, ''I.R.S. Audits Middle Class More Often, More Quickly,'' *The New York Times*, C1 (Apr. 16, 2007) (''The core of the new [IRS] strategy is to audit more individuals and businesses, even if the examinations are more cursory.''); Johnston, ''I.R.S. Feels Pressed to End Cases,'' *The New York Times*, C1 (Mar. 20, 2007) (''The head of the Internal Revenue Service faces questions in Congress today about auditors' complaints that they are being forced to close corporate cases prematurely, allowing billions in tax dollars to go unpaid.''); and W. Edward Afield, ''Agency Activism as a New Way of Life: Administrative Modification of the Internal Revenue Code Through Limited Issue Focused Examinations,'' 7 *Fla. Tax Rev*. 455, 457 (2006). (''In the name of increasing efficiency and better utilizing limited resources, the IRS has begun to adopt audit policies that overly favor taxpayers and greatly hinder the IRS's ability to perform thorough audits.'')

[46]*See, e.g.*, *Randall Bishop et ux. v. Commissioner*, T.C. Memo. 2001-82, *Doc 2001-9862*, *2001 TNT 66-12*. (''In reviewing petitioners' substantiation schedule to determine the adequacy of the alleged substantiation, we note that 'business purpose' is often referred to in cryptic terms, e.g., 'open,' 'close,' 'partial,' 'A.L. T.D.A.,' 'LNL,' 'RLTY,' etc.'')

[47]*See* tax and notes *supra* 21-22.

[48]Even if the directly related or associated tests cited in the regulations are met, as a practical matter we question whether legitimate business activities can realistically transpire before, during, or after the majority of entertainment events. Consider business entertainment in the form of tickets to a professional sports event. Before the game, people typically are fighting traffic or scurrying around the stadium scouting for good parking. During the game, everyone is typically focused on events transpiring on the field, court, etc. After the game (which usually ends late in the afternoon or late at night), attendees are typically feeling drained from being in the sun, rain, heat, or cold for several hours. None of the foregoing circumstances is conducive to a business environment in which meaningful exchanges can transpire.

[49]*See, e.g.*, *Detko v. Commissioner*, T.C. Memo. 1987-99 (doctors who went on a pleasure boat with an anesthesiologist taxpayer testified on his behalf that they had spoken about medical affairs while on the boat).

- A rabbi, motivated to enhance his standing in his congregation, invited his synagogue's entire membership to his son's bar mitzvah and attempted to deduct the costs.[50]
- A dentist hosted parties for faculty and students of the school at which his wife was a teacher, and he attempted to deduct the associated expenses under the pretense that the parties would enhance his business contacts.[51]
- A lawyer hosted a lavish birthday party and attempted to deduct the cost because the majority of his guests were clients and fellow law partners.[52]

In none of those examples was the taxpayer penalized for his aggressive tax position. With such limited downside risk, questionable taxpayer activity in the sphere of deductible business entertainment expenses is undoubtedly widespread.

3. Deductibility favors the wealthy. It is in the nature of hierarchical organizations that discretion to incur business expenses is vested primarily in the middle to senior managers of the enterprise. It follows that when those expenditures involve substantial personal consumption elements, the benefits are disproportionately enjoyed by those at the upper levels of the organization.

This is widely understood, and deeply resented, by the general public. Congress has responded (although, as we argue, too timidly) in the form of the percentage disallowances in section 274(n), discussed above. Noting the tendency for business entertainment expenditures to be particularly lavish and enjoyed primarily by taxpayers with high incomes, the Joint Committee on Taxation expressed Congress's concern:

> This disparity is highly visible, and has contributed to public perceptions that the tax system under prior law was unfair. Polls indicated that the public identified the full deductibility of normal personal expenses such as meals and entertainment tickets to be one of the most significant elements of disrespect for and dissatisfaction with the tax system.[53]

Also, a deduction that inures primarily to the benefit of higher socioeconomic classes has a perverse revenue effect: Virtually every business entertainment dollar deducted costs more revenue on a transaction-by-transaction basis than deductions claimed by middle- or lower-income taxpayers because of both the higher marginal tax rates of the higher-income taxpayers and the greater propensity of those taxpayers to itemize their deductions. From a revenue perspective, because business entertainment deductions are more costly per expense dollar than other deductions, their availability warrants heightened scrutiny.

4. The generation of goodwill is not predicated on superior service/product price and quality. In an ideal world, business goodwill would be the result of offering superior products and services at the most reasonable prices possible. At the opposite end of the goodwill generation spectrum lies a darker region of commercial bribery: Goodwill of a sort (scarcely worthy of the name) can be bought with under-the-table payments to a disloyal agent of the client or customer.[54] Although we do not suggest that business entertainment and commercial bribery are identical, it may be educational, even shocking, to note that some definitions of "commercial bribery" come very close to encompassing business entertainment. *Black's Law Dictionary* defines "commercial bribery" as "dealing with the agents or employees of prospective buyers to secure an advantage over business competitors."[55] A fundamental distinction between commercial bribery and business entertainment is that a proffered bribe is ordinarily accompanied by a more or less explicit quid pro quo benefit to the party offering the bribe. By contrast, business entertainment is far more genteel, without any direct or immediate expectation that business entertainment guests are indebted to purchase the host's services or products.

Still, the similarities between commercial bribery and business entertainment expenses are striking. Business entertainment, like a cash payment under the table, forges bonds and attracts potential and existing clients to use the host's services or purchase the host's products while having nothing whatsoever to do with the quality or price of the services or products being offered.[56] Admittedly, commercial bribes are usually cloaked in secrecy, whereas business entertainment expenditures are not. However, the explanations of that difference have more to do with transactional size and social mores than with the underlying substance of the transaction. Business entertainment can subtly pass as a form of token friendship. Cold cash fails to generate that benign allure. One wonders, however, how much difference there is, in

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[50] *Feldman v. Commissioner*, 86 T.C. 458 (1986); *see also Brecker v. Commissioner*, T.C. Memo. 1972-6 (the taxpayer attempted to deduct the cost of business associates' attendance at his son's bar mitzvah under the theory that the event would boost employee morale); *Leubert v. Commissioner*, T.C. Memo. 1983-457 (the taxpayer, under the same theory, attempted to deduct part of his daughter's wedding reception).

[51] *Chapman v. Commissioner*, 48 T.C. 358 (1967).

[52] *Lennon v. Commissioner*, T.C. Memo. 1978-176.

[53] JCT, "General Explanation of the Tax Reform Act of 1986," at 61 (1986).

[54] We are alluding to the pervasive agency problem in corporate governance, first described in detail by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property* (1932). Briefly, the thesis is that large corporations are typically managed by people who are not the owners of the corporation and that the managers have incentives that often diverge from those of the owners. In the example of a purchasing agent, it is clear that his enjoyment of entertainment provided by a would-be supplier has little to do with the optimal decision about choice of supplier but potentially has a great deal to do with the purchasing agent's preferences. That somewhat unsavory aspect of business entertainment expenditures will be explored in greater depth in a more comprehensive version of this article currently in preparation.

[55] *Black's Law Dictionary*, 204 (8th ed. 2004).

[56] *See* Franklin A. Gevurtz, "Commercial Bribery and the Sherman Act: The Case for Per Se Illegality," 42 *U. Miami L. Rev.* 365, 391 (1987) (commercial bribery allows perpetrators to "avoid competition, thereby maintain[ing] higher prices (or poorer quality)").

intention and effect, between an all-expense-paid trip to the Super Bowl and a simple cash payment of equivalent value.

Although the regulations specifically bar the deduction of expenditures intended merely to generate goodwill,[57] it seems clear that the vast majority of business entertainment expenses are indeed designed to generate a significant future benefit. And, as noted, they also share a loose kinship with commercial bribery.[58] In light of those characteristics, business entertainment expenditures should be accorded the unfavorable tax treatment that the code and case law explicitly demand of those counterparts. Apart from advertising, expenses that produce significant future benefits such as the generation of goodwill are generally nondeductible,[59] and deductions of illegal bribes are disallowed.[60] There is no justification for not extending that deduction prohibition to business entertainment expenses as well.

D. Proposal

Congress correctly perceived the problems inherent in deductions for business entertainment when it partially eliminated those deductions in 1986 and cut them further in 1993. Still, its response was too modest. In light of the fact that the primary justification of business entertainment is, at its core, morally reprehensible, and that the swelling deficit lends urgency to the elimination of all unnecessary deductions, it is clear that the time has come to deny the deduction of business entertainment expenditures. This section delineates what should be done.

First, Congress should add a new clause to section 274(a)(1) specifying that the deductibility of any entertainment expense is disallowed. The regulations under section 274 can continue to elaborate on what constitutes ''entertainment expenses.''[61] By instituting this deduction prohibition, Congress would have to modify or eliminate other provisions, such as section 274(d) and (n).

Second, Congress should invite the Treasury to promulgate new regulations that more narrowly define the meaning of ''entertainment.'' In particular, expenses that are incurred in a clear business setting and that are deeply rooted in producing immediate income or in mining future income prospects (for example, a hospitality tent) would remain deductible. Those expenses are more in the nature of promotional activity than entertainment.[62] By narrowing the definition of the term ''entertainment,'' while simultaneously expanding the definition of the term ''promotional,'' Congress would endorse good business practices while preserving the code's integrity.

Third, Congress should shift taxpayers' calculation of the costs and benefits in this area by imposing an automatic accuracy-related penalty on taxpayers who either deduct their entertainment expenses or misclassify nondeductible entertainment expenses as deductible promotional expenses.[63] That automatic penalty would share the same features of the existing automatic accuracy-related penalty for substantial understatements[64]: A 20 percent penalty would apply to the tax generated by the disallowed deduction. Perfect enforcement (or even much-improved enforcement) of the tax laws may be too much to hope for, but the terms of the audit lottery can certainly be adjusted to be far less favorable to those who would abuse the tax rules.[65]

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[57]For business entertainment expenses to be deductible, according to the regulations, ''the taxpayer [must have] more than a general expectation of deriving some income or other trade or business benefit (*other than the goodwill* of the person or persons entertained).'' Reg. section 1.274-1(c)(3)(i) (emphasis added).

[58]Indeed, the Foreign Corrupt Practices Act, 15 U.S.C. section 78dd-2, specifically includes as part of its prohibition against the bribery of foreign officials, with certain narrow exceptions, the giving of any item of value. The Securities and Exchange Commission has prosecuted companies that have violated this statute by underwriting the entertainment of foreign officials. *See, e.g.*, *SEC v. Lucent Techs. Inc.*, Civ. Act. 1:07-cv-02301 (filed Dec. 21, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20414.htm (the SEC filed a suit against Lucent Technologies Inc. in connection with payments for Chinese officials' travel and entertainment expenses; the company agreed to pay a $1.5 million civil penalty).

[59]Section 263; *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992).

[60]Section 162(c)(2).

[61]*See* reg. section 1.274-2(b)(1)(i). (''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.'')

[62]The vast majority of current entertainment expenses incurred at nightclubs, cocktail lounges, theaters, country clubs, golf courses, and athletic and sporting events and on hunting, fishing, vacation, and similar trips would fall outside the ambit of being promotional in nature. Reg. section 1.1274-2(b)(1)(i).

[63]In regulations promulgated under section 274, the Treasury has made clear that the term ''entertainment'' is not synonymous with ''expenditures for advertising or public relations.'' Reg. section 1.274-2(b)(1)(ii).

[64]Section 6662(b)(2) and (d).

[65]Consider how adoption of the suggested reforms would operate in practice. A taxpayer is eager to lure new patients to her orthodontist practice. She decides to use a two-prong approach. The first prong is to sponsor lectures on dental hygiene for parents of students at local middle schools. During her hour-long presentation, the taxpayer distributes brochures promoting her practice. A luncheon follows each presentation. The second promotional prong is to host a series of patient-appreciation events held at a professional baseball skybox. The skybox costs $4,000 per game, or $1,000 a ticket, and three clients and the taxpayer attend each event. Before the game, the taxpayer delivers a short 10-minute lecture updating her patients on the latest advances in dentistry. If Congress instituted the proposed reforms, the taxpayer could deduct the promotional costs of the school luncheons, but the costs for the baseball skybox would be disallowed. If the taxpayer nevertheless deducted the skybox costs, the following tax consequence would befall her (assuming a 35 percent marginal tax rate): On the disallowed $4,000 deduction, she would have to pay $1,400 of taxes (35 percent x $4,000), interest, and an accuracy-related penalty of $280 (20 percent x $1,400).

E. Revenue Estimate

Eliminating the deduction for business entertainment expenses would generate a significant amount of much-needed revenue, although the exact amount is very difficult to estimate. For individual employees, business entertainment expenses are classified as "unreimbursed employee expenses" and are lumped together with a series of other similar expenses, including those for travel, transportation, and meals.[66] Once taxpayers record that amalgamated figure on their tax returns, it's nearly impossible to later separate its internal components. The same fate befalls business entertainment expenses incurred by employers and business owners. For income tax reporting purposes, those expenses are amalgamated with other expenses for travel and meals.[67]

In the only study that directly scrutinized business entertainment expenditures,[68] the Library of Congress in 1979 determined that if Congress were to enact legislative reforms similar to the ones we propose, approximately $1.2 billion of revenue could be raised annually. Since the issuance of that study 30 years ago, GDP has grown nearly sixfold,[69] suggesting that the revenue generation associated with this proposal could easily exceed $7 billion annually. However, because Congress has somewhat restricted the deductibility of entertainment expenses since 1986 (for example, imposing a 50 percent deduction limitation under section 274(n), as well as adding restrictions on club dues and the like),[70] a more realistic estimate of the amount of revenue our proposal would raise annually would be in the neighborhood of $4 billion to $5 billion.[71]

In addition to the positive direct revenue effects, we predict that adoption of our proposal would have salutary effects on taxpayer morale, which would also yield additional revenue (although measurement of this sort of increment is even more difficult than projection of the direct revenue effects). Business entertainment expenses sow the seeds of taxpayer frustration because those with less income bear witness to those with more income enjoying the fruits of consumption (that is, entertainment) on a pretax basis. Study after study indicates the negative behavioral effects associated with taxpayer frustration of that sort.[72] Also, the IRS has to institute labor-intensive efforts to investigate the nature of business entertainment expenses. Those are resources that could be deployed more efficiently and productively monitoring big-ticket items such as abusive tax shelters and hidden offshore accounts.

We believe that the indirect costs associated with the deductibility of business entertainment expenses equal or exceed the estimated direct costs described above. If our conclusion is correct, the revenue generated by eliminating the deduction of business entertainment expenses could easily exceed $10 billion annually, a figure worthy of any politician's eye, particularly a politician serious about the code's integrity and the spiraling deficits engulfing the nation.

[66]*See* Instructions, Schedule A, Form 1040, at A-9 (2008); *see also* section 67(a).

[67]*See* Instructions, Schedule C, Form 1040, at C-7 (2008); Instructions, Form 1120, at 12 (2008).

[68]Library of Congress, "The Proposed Curtailment of the Deduction for Business Expenses: General Issues and the Employment Impact in the Restaurant Industry," *Daily Tax Report* (BNA), Feb. 27, 1978, at J-3.

[69]Author estimate based on analysis of information on the Commerce Department's Bureau of Economic Affairs Web site. The GDP in 1979 was approximately $2.5 trillion, and in 2008 it was approximately $14.4 trillion.

[70]*See generally* Part A above for a description of those rules.

[71]Our estimates also generally conform to those of a study conducted by Citizens for Tax Justice. *See* Robert S. McIntyre, *The Hidden Entitlements* (1996), *available at* http://www.ctj.org/hid_ent/part-2/part2-5.htm.

[72]*See, e.g.*, Bruno Frey and Benno Torgler, "Tax Morale and Conditional Cooperation," 35 *J. of Comparative Economics* 136 (2007); Steven M. Sheffrin and Robert K. Triest, "Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance," in *Why People Pay Taxes*, 193 (Joe Slemrod ed. 1992). *See generally* Benno Torgler, *Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis* (2007); Edward J. McCaffery, "Cognitive Theory and Tax," 41 *U.C.L.A. L. Rev*. 1961 (1994).