

Part E. Tax Abuses--Mixed Business/Personal Use

Many expenses that involve significant personal consumption currently are being deducted as business expenses. This is unfair to taxpayers who do not have access to business perquisites and also distorts consumption choices. The proposals would limit deductions for entertainment, business meals, and travel expenses.

**LIMIT DEDUCTION FOR  
ENTERTAINMENT AND BUSINESS MEAL EXPENSES**

**General Explanation**

**Chapter 3.11**

**Current Law**

Ordinary and necessary expenses paid or incurred during a taxable year generally are deductible if the expenses bear a reasonable and proximate relation to the taxpayer's trade or business or to activities engaged in for profit. Although ordinary and necessary business expenses may include entertainment expenses, business entertainment expenses are deductible only if they satisfy certain additional requirements.

Business meals are deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during, or after the meal. Expenses for other entertainment activities are deductible only if they are "directly related to" or "associated with" the taxpayer's trade or business. Entertainment activities are considered "directly related" if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity. The taxpayer need not show that income actually resulted from the entertainment. In general, entertainment expenses satisfy the "associated with" standard if they are directly preceded or followed by a substantial and bona fide business discussion. A business discussion may be considered substantial and bona fide even if it consumes less time than the associated entertainment and does not occur on the same day as the entertainment activity.

Deductions for entertainment facilities, such as yachts, hunting lodges, or country clubs, used to entertain clients or customers also are subject to certain restrictions. A deduction is allowed for the portion of the cost of club memberships that are "directly related" to the taxpayer's business if the facilities are used primarily for business purposes. No deduction is allowed for other types of entertainment facilities. Tickets to sporting and theatrical events, and the costs of skyboxes, lounges, boxes or other similar arrangements that provide the taxpayer a specific viewing area to a sporting or theatrical event, however, are not considered to be expenses related to an entertainment facility. Thus, such expenses are fully deductible if they meet the "directly related to" or "associated with" tests for entertainment activities.

Business entertainment expenses also are subject to separate substantiation requirements. Deductions for entertainment expenses must be supported by records showing the amount of the expense, time and place of entertainment, business purpose of the expense, and business relationship to the taxpayer of any persons entertained.

## Reasons for Change

**In General.** The subject of business entertainment expenses has received repeated legislative attention since 1962, when Congress first applied special restrictions to the deduction of such expenses. The continuing concern in this area reflects the difficulty of identifying the business component of expenses that have obvious personal benefits and are commonly incurred in nonbusiness contexts.

Although there are special restrictions on the deduction of business entertainment expenses, current law has largely maintained a facts and circumstances approach in determining whether entertainment expenses were incurred for business rather than personal purposes. The existing "directly related to" or "associated with" tests require investigation of a taxpayer's expectations and intentions. It frequently is possible under those tests to demonstrate an actual business purpose or connection for an entertainment expense that nevertheless has a strong, if not predominant, element of personal consumption. Thus, under present law, the costs of country club memberships, football and theater tickets, parties, and lunches and dinners at expensive restaurants are all deductible where a reasonable business connection can be demonstrated. Indeed, such deductions may be allowed even in cases where less time is devoted to business than to entertainment, no business is discussed, or the taxpayer is not even present at the entertainment activity.

The liberality of the law in this area is in sharp contrast to the treatment of other kinds of expenses that provide both business and personal benefits. In some cases, such as work-related clothing, the presence of any personal benefit is deemed sufficient reason to disallow any deduction. In other cases, taxpayers are allowed to deduct only the portion of expenses allocated to business. In contrast, present law often allows full deductibility of entertainment expenses that entail substantial personal consumption.

**Fairness.** The current treatment of business entertainment expenses encourages taxpayers to indulge personal entertainment desires while at work or in the company of business associates. The majority of taxpayers, however, do not benefit from this incentive. Most hold jobs that do not permit business entertainment, and many others are scrupulous in claiming business deductions for personal entertainment.

Current law thus creates a preference for the limited class of taxpayers willing and able to satisfy personal entertainment desires in a setting with at least some business trappings. Lunches are deductible for a business person who eats with clients at an elegant restaurant, but not for a plumber who eats with other workers at the construction site. The cost of tickets to a sporting event for friends of a business person is deductible if they are business associates, but the cost of tickets for friends of a secretary, sales clerk, or nurse must be paid for with after-tax dollars.

Extreme abuses of these deductions are commonly cited by those who assail the tax system as unfair. Such abuses may be limited to a relatively small number of taxpayers, but they nevertheless undermine the public trust that is essential in a tax system based on self-assessment. Taxpayers are not only aware of the abuses, they perceive an inability under current law to police them. Absent public confidence that the rules apply on the same basis to all, disrespect for the system and greater noncompliance are inevitable. The adoption of workable limitations on the deductibility of entertainment expenses would be an important step to preserve that confidence.

**Efficiency.** The treatment of "business related" entertainment under current law also encourages excessive spending on entertainment. The business person in the 40 percent marginal tax bracket considering whether to spend \$20 or \$50 on a "business meal" knows that the \$30 extra cost of the more expensive meal is reduced to \$18 because of the available deduction. The taxpayer's choice of meals is more likely to be based on personal rather than business considerations, but the deductibility of the expense makes selection of the expensive meal more likely than in a nonbusiness context. Similarly, a business person in the 50 percent marginal tax bracket may conclude that it costs nothing extra to take a business associate to the theater even if it serves little or no business purpose. The attendance of the business associate permits a claim that the cost of both tickets is deductible, and thus the extra ticket may cost nothing on an after-tax basis.

Present law has no effective response to these practices because it characterizes an entertainment expense as business or personal on the basis of the taxpayer's intentions and purposes. Once a business purpose or connection is established, it ordinarily permits the entire expense to be deducted, even though the total amount spent reflects what is in essence a choice about the level of personal consumption.

### Proposals

1. No deduction would be allowed for entertainment activity expenses. Entertainment activity expenses, however, would be exempted from the general disallowance rule if they: are paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement); are treated as compensation by an employer and taken into account as wages by an employee; constitute recreational expenses for employees (e.g., Christmas parties and summer outings); are expenses for goods, services, and facilities made available to the general public (e.g., samples and promotional activities); or are expenses includable in income of persons who are not employees.

2. A deduction would be allowed for the cost of ordinary and necessary business meals furnished in a clear business setting (as defined in Treasury regulations). To the extent the total cost of a

business meal exceeds \$25 times the number of persons participating in such meal, 50 percent of such excess would be nondeductible. The meal cost limitation would include gratuities and tax with respect to the meal. However, expenses for food and beverage furnished on the business premises of the taxpayer primarily for employees of the taxpayer would not be subject to the limitation.

#### Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

#### Analysis

**Business Meal Limitations.** Business meals provide a mixture of business and personal benefits. The extent to which a meal provides a personal benefit will vary, and it is not possible to develop rules that would specify the precise percentage of personal benefit in individual cases. The proposal, therefore, establishes a relatively mechanical limitation on the deductibility of business meals, targeted at meal expenses that are most likely to provide a significant level of personal consumption. The \$25 allowance is intentionally quite generous and is intended to provide a full deduction for the vast majority of business meals. The deduction will be disallowed only for 50 percent of the portion of the cost of a business meal that is in excess of \$25.

Representatives of the restaurant industry in testimony before Congress have provided several estimates of the average cost of restaurant meals. If adjusted for inflation, those estimates would range between \$7.50 and \$11.50 for 1986. In addition, Census data shows that only about 2.5 percent of all restaurant meals in 1977 were in restaurants where the average bill exceeded \$10.00. Adjusted for inflation, this suggests that only about 2.5 percent of all meals were in restaurants with average bills over \$19.00 in 1986. Recent surveys suggest that less than 15 percent of all business meals would be affected by the proposal in 1986.

While the proposal will reduce the number of expensive business meals, it is expected that the limitations will not have a significant impact on more than five percent of restaurants. Moreover, since some high-cost meals will be replaced by moderate-cost meals, the effect on total employment in the restaurant industry is expected to be modest.

Businesses currently are required to keep detailed records for all deductible meals. Therefore, the additional recordkeeping costs should be minimal.

Placing a limit on the deductibility of business meals would eliminate the extreme cases of abuse -- those that offend the average

taxpayer the most. Despite its small revenue effect, the proposal would be of significant assistance in restoring trust in the tax system.

The Elimination of Other Entertainment Deductions. The proposal would completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the costs of fishing trips, and country club dues. Because all such entertainment has a large personal component, the proper tax treatment, on both efficiency and equity grounds, is to disallow a deduction.

Approximately one-third of all baseball tickets and over one-half of all hockey tickets are purchased by businesses. The net effect is often to raise the cost of tickets for those who are not subsidized through the tax system for their purchases. Some performing arts organizations also sell large proportions of their tickets to businesses. Some tickets bought by businesses would remain deductible if the tickets are made available to the general public as a promotion under current law standards.

## LIMIT DEDUCTION FOR TRAVEL EXPENSES

### General Explanation

#### Chapter 3.12

#### Current Law

Travel expenses incurred by a taxpayer while "away from home" are deductible if such expenses are reasonable and necessary in the taxpayer's business and are directly attributable to the taxpayer's business. Travel expenses may include the cost of travel to and from the destination and the cost of meals, lodging, and other incidental travel costs (e.g., laundry, taxi fares) incurred while at the business destination. A taxpayer's "home" for purposes of the deduction is generally his or her business headquarters. A taxpayer is considered to be "away" from his or her business headquarters only if the travel involves a "temporary" rather than an "indefinite" assignment at another location. If a taxpayer accepts a job at a distant location for an indefinite period, the new job location becomes the taxpayer's tax home. Temporary employment generally is expected to last for a short or foreseeable period of time, but whether employment is temporary or indefinite is essentially a factual question.

The costs of attending a convention or other meeting (including the costs of meals and lodging) in the North American area are deductible if the taxpayer is able to show that attendance at the convention is directly related to his or her trade or business and that such attendance is advancing the interests of the taxpayer's trade or business. The North American area includes the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada, Mexico, and certain Caribbean countries that have entered into exchange of tax information agreements with the United States. A stricter rule applies for conventions held outside the North American area. In order to claim a deduction for the costs of attending such a convention, a taxpayer also must show that it was "as reasonable" for the meeting to be held outside the North American area as within it.

Deductions for conventions, seminars, or other meetings held on cruise ships are subject to additional limitations. No deduction is allowed unless the cruise ship is registered in the United States and stops only at ports of call in the United States or in possessions of the United States. In any event, a taxpayer may deduct no more than \$2,000 for such meetings per year.

Professional education expenses, including travel as a form of education, are deductible if the education maintains or improves existing employment skills or is required by an employer, or applicable law or regulation. To be deductible, the travel must be

directly related to the duties of the taxpayer in his or her employment or other trade or business. The deductible educational travel may occur while the taxpayer is on sabbatical leave.

### Reasons for Change

The present limitations on deductions for business travel fail to distinguish adequately between costs incurred for business purposes and costs reflecting personal consumption. The deduction for expenses for meals and lodging incurred "away from home" is premised on the assumption that the business traveler incurs additional costs while away from home. Restaurant meals are likely to be more expensive than the cost to the taxpayer of eating at home, and hotel accommodations are a duplicative expense for the taxpayer who maintains regular living quarters elsewhere. These excess costs incurred by a taxpayer away from home may reasonably be treated as legitimate business expenses.

Extended travel status, however, generally permits economies not available on shorter trips. The temporary residence of a taxpayer expecting to be away from home for a year or more typically will have kitchen, laundry, and other facilities that permit the taxpayer to avoid excess expenses. Moreover, extended travel may permit the taxpayer to abate fixed costs associated with his permanent residence, such as by renting or subletting his house or apartment.

In addition, the current tax treatment of travel that has both business and personal elements creates opportunities for abuse that threaten public confidence in the system. Current law largely retains a facts and circumstances approach to the characterization of such mixed motive expenses, and thus requires investigation of the taxpayer's particular intentions and expectations. The fact that a plausible business purpose frequently can be established for travel that has a strong personal component encourages taxpayers, in a system of self-assessment, to take aggressive reporting positions. The great majority of taxpayers are honest, and apply current law standards in good faith. It is not reasonable, however, to expect that taxpayers deny themselves the benefit of the doubt when applying rules that are broad and open to interpretation.

The issues identified above are characteristic of a system that emphasizes fairness of individual results, and thus avoids the rougher justice achieved by mechanical, bright-line rules. Without challenging these priorities in any fundamental way, it is still appropriate to recognize that the integrity of the system ultimately depends on rules that taxpayers respect and perceive that others respect. This is especially so with regard to deductions for expenses, such as travel, that most taxpayers undertake strictly for personal purposes and that have obvious personal consumption benefits. Accordingly, strict limitations on deductions for travel expenses are appropriate where the component of personal consumption is manifest or where business and personal motivations are so intertwined as to be inseparable.

## Proposals

1. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and no travel deductions would be allowed.

2. No deduction would be allowed for business travel by ocean liner, cruise ship, or other form of luxury water transportation in excess of the cost of otherwise available business transportation, unless the taxpayer provides proof of existing medical reasons for utilizing such transportation.

3. No deduction would be allowed for expenses paid with respect to conventions, seminars, or other meetings held aboard cruise ships.

4. No deduction would be allowed for travel as a form of education.

5. The limitations set forth in 2. through 4. above would not apply in cases where the expenses in question are paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement); are treated as compensation by an employer and taken into account as wages by an employee; or are expenses includable in income of persons who are not employees.

## Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

## Analysis

The proposed limitations on certain travel expense deductions are designed to restrict deductions for travel expenses where personal consumption benefits are most evident without unduly restricting deductions for legitimate business expenses.

The one-year rule for defining temporary employment would eliminate a significant source of dispute between taxpayers and the Internal Revenue Service, and would provide a reasonable division between temporary and indefinite assignments. One year's stay at a single location is sufficient to indicate that regular living patterns will be established at the new location and, thus, that food and lodging expenses need not be duplicative of or more expensive than comparable costs at the original job site.

The disallowance of a deduction for the cost of travel by cruise ships, ocean liner, or other form of luxury water transportation in excess of the cost of otherwise available business transportation is intended to deny a deduction for the portion of the travel cost most likely to constitute personal rather than business benefit.