[COMMITTEE PRINT]

TAX REDUCTION AND REFORM PROPOSALS

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BUSINESS EXPENSE DEDUCTIONS

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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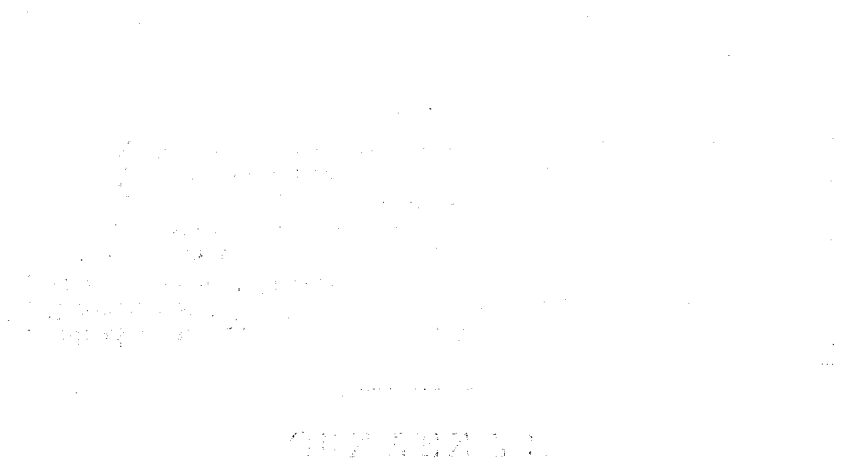
CONTENTS



I. INTRODUCTION

This pamphlet is the fifth in a series prepared by the staff of the Joint Committee on Taxation for the Committee on Ways and Means for its consideration of the Administration's tax reduction and reform proposals. A previous staff pamphlet (dated January 27, 1978) provided an overall summary of the Administration's tax proposals.

This pamphlet describes in detail the Administration proposals regarding the deduction of certain business-related expenses. This description includes, for each of the specific proposals, an explanation of present law, the background of the item (including legislative history), the Administration proposal, as well as a description of Members' proposals, and issues involved in the various proposals. In addition, the material in this pamphlet includes the estimated revenue effect for the Administration proposals.

A brief summary of the specific Administration proposals (and the related present law) precedes the detailed description of the proposals. The detailed description covers business expense deduction proposals regarding the following: (1) entertainment expenses; (2) business entertainment meals; (3) travel expenses for airfare; and (4) foreign convention expenses.

(Other pamphlets cover proposals concerning certain other business expense deductions, including the treatment of taxes paid in respect to the acquisition of capital assets used in a trade or business and depreciation deductions.)

II. SUMMARY OF ADMINISTRATION PROPOSALS

A. Entertainment Expenses

Present law

Ordinary and necessary expenses paid or incurred during the taxable year generally are deductible if they bear a reasonable and proximate relation to the taxpayer's trade or business, or to activities engaged in for profit, and so long as the expenses are reasonable in amount. Ordinary and necessary business expenses which are deductible may include the cost of entertainment.

In addition to the general ordinary and necessary standard for deductibility, special rules apply to entertainment expenses. Generally, expenses for an entertainment "activity" are deductible under the special rules only if, and to the extent that, the expenses are directly related to or associated with the active conduct of a trade or business. Expenses with respect to an entertainment "facility" are deductible under the special rules only if the facility is used primarily for the furtherance of the taxpayer's trade or business and only to the extent the expenses are directly related to the active conduct of a trade or business. These special rules do not apply to business meals.

Administration proposal

In general, the Administration proposes the disallowance of deductions for entertainment activities and facilities (other than for business entertainment meals).

B. Business Entertainment Meals

Present law

In general, present law provides that expenditures for business meals are deductible to the extent that they are ordinary and necessary, not extravagant or lavish, and are paid or incurred in connection with the taxpayer's trade or business or income producing activities. Business meals are deductible, generally, when furnished to an individual under circumstances conducive to business discussions, taking into account the surroundings in which furnished, the trade, business or income producing activities of the taxpayer, and the business relationship of the individual to whom such meal is provided.

Administration proposal

Under the Administration's proposal, a deduction for any business entertainment meal which is not treated as compensation to the recipient would be allowed only to the extent of 50 percent of the cost of the meal. Similarly, the cost of membership dues and fees paid to clubs operated solely to provide business meals would be allowable as a deduction only to the extent of 50 percent of the cost.

C. Travel Expenses

Present law

Under present law, travel expenses generally are deductible if they are paid or incurred away from home in connection with the taxpayer's trade or business or in pursuit of an activity engaged in for profit.

Administration proposal

The Administration proposes to limit the amount deductible for commercial airfare to the cost of coach airfare (i.e., the lowest-priced generally available airfare).

D. Foreign Convention Expenses

Present law

Generally, no deduction is allowed for the expenses of attending more than two foreign conventions in any year. Attendance requirements, subsistence limitations, and coach air fare limitations apply with respect to the expenses incurred in connection with the two foreign conventions for which expenses may be deducted.

Administration proposal

Under the Administration proposal, the expenses of attending a foreign convention would be deductible only if it was as reasonable to hold the convention outside the United States (including its possessions) as within the United States. For conventions satisfying this test, deductible subsistence expenses could not exceed 125 percent of the Federal per diem for the convention site.

III. DESCRIPTION AND DISCUSSION OF BUSINESS EXPENSE DEDUCTION PROPOSALS

A. Entertainment Expenses

Present Law

In general

Under present law, deductions are allowable for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business or for the production of income (secs. 162 and 212). Whether an expense is ordinary and necessary depends largely upon the particular facts and circumstances involved in each case. Ordinary and necessary business expenses which are deductible may include the cost of club dues or fees, meals, and other entertainment activities and facilities. However, entertainment expenses are deductible only if they satisfy certain substantiation requirements (sec. 274).

Generally, no deduction is allowed for entertainment expenses unless the taxpayer substantiates by adequate records, or by sufficiently corroborative evidence, (1) the amount of the expense, (2) the time and place of its occurrence, (3) its business purpose, and (4) the business relationship to the taxpayer of the person or persons entertained (sec. 274(d)). In addition, ordinary and necessary expenses are deductible only if the expenses are allocable to the taxpayer's business, and are reasonable in amount, i.e., not lavish or extravagant. Generally, if entertainment expenses are paid or incurred both for business and nonbusiness purposes, only the portion of the expenses allocable to the business purpose is deductible (see, however, the rules relating to entertainment facilities discussed below).

Entertainment activities

With respect to entertainment "activities," no deduction is allowed for entertainment expenses unless the taxpayer can establish that they are either directly related to, or associated with, the active conduct of the taxpayer's business. For this purpose, entertainment means any activity of a type generally considered to constitute entertainment, amusement, or recreation. Thus, it includes entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation, and similar trips. However, these special requirements for deductibility generally do not apply to business entertainment meals.

Under "the direct relationship" test, an entertainment expense is considered to be directly related to the active conduct of the taxpayer's business if the taxpayer (1) had more than a general expectation of generating income at some indefinite time as a result of making the expenditure, (2) actually engaged in a bona fide business meeting, negotiation, discussion, or other business transaction during the entertainment which was directed toward some specific advancement of the business, and (3) had reason to believe that the principal

25-086—78——2

character or aspect of the combined business and entertainment to which the expense was related was the active conduct of the business. The direct relationship test also is satisfied if the entertainment takes place in a clear business setting, where the recipient of the entertainment reasonably would know that the taxpayer had no significant motive for incurring the expense other than the direct furtherance of the business. In addition, the direct relationship test is satisfied if (1) the expenditure is in the nature of compensation for services to a recipient other than an employee (for example, vacations supplied by a manufacturer to retailers for exceeding specified sales quotas or goals), or (2) the expenses are attributable to a facility used by the taxpayer to furnish food or beverages under circumstances generally considered to be conducive to business discussions, e.g., working lunch meetings.

Expenses for entertainment "activities" which do not meet the requirements of the direct relationship test may be deductible under the "associated with" test if the entertainment directly precedes or follows a substantial and bona fide business discussion, e.g., attending a theater performance after a business discussion. Generally, an expenditure is considered "associated with" the active conduct of the taxpayer's trade or business if the taxpayer establishes a clear business purpose in making the expenditure, such as to obtain new business.

Whether a business discussion is substantial and bona fide largely is a factual determination which depends upon the taxpayer's demonstration of an active business meeting, negotiation, discussion, or transaction engaged in for the purpose of obtaining a specific business benefit, and that the discussion, etc., was substantial in relation to the entertainment which preceded or followed it. A business or professional convention is considered to be a substantial and bona fide business discussion under the associated with test if the expenses of attending the convention or meeting are ordinary and necessary business expenses, and if the principal activity of the meeting is a scheduled program of business activities.

Entertainment expenses incurred during the course of a business trip away from home must meet the requirements for deductibility of entertainment expenses independently of the deductibility of the travel expenses.

If only a portion of the entertainment expenses qualifies under either the directly related or associated with tests, the allowable deduction may not exceed that portion of the expenses.

Entertainment facilities

Expenses with respect to entertainment "facilities," may be deductible if (1) they are ordinary and necessary, (2) the facility is used primarily for the furtherance of the taxpayer's business (i.e., more than 50 percent of the time that it is used), and (3) the expense in question is "directly related" to the active conduct of the taxpayer's business.

For this purpose, an entertainment facility is any item of personal or real property owned, rented, or used by a taxpayer during the taxable year for, or in connection with, entertainment. For example, entertainment facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes,

apartments, hotel suites, and vacation homes. However, a facility is not considered to be an "entertainment facility" if it is only used incidentally during a taxable year in connection with entertainment and that use is insubstantial. In the case of individuals and subchapter S corporations, apartments, hotel suites, vacation homes, and boats may also be subject to "vaction home" special disallowance rules if there is a certain amount of personal use of the facility, i.e., the personal use exceeds the greater of 14 days or 10 percent of rental days.

If an item of property is considered to be an entertainment facility, the expenditures subject to the special entertainment facility rules include depreciation, rent, utility charges, maintenance and repair expenses, insurance premiums, salaries for caretakers and watchmen, and losses realized on the sale or other disposition of the property. These expenditures also include dues and fees paid to any social, athletic, or sporting club or organization.[1] However, expenditures are not treated as being made with respect to a facility if they are out-of-pocket expenses, e.g., nonoperating costs such as expenditures for food and beverages. In addition, expenses attributable to a non-entertainment use of a facillty are not treated as being expenses with respect to an "entertainment" facility, e.g., the use of an automobile or airplane for business travel purposes. Finally, expenses which are deductible without regard to their connection with a taxpayer's trade or business are not considered to be expenditures with respect to an entertainment facility, e.g., taxes, interest, and casualty losses.

In determining whether an entertainment facility is used primarily for business purposes, all the ordinary and necessary business use of the facility may be taken into account even though the use is not "directly related to" or "associated with" the active conduct of the taxpayer's profit-seeking activities (Rev. Rul. 63–144, 1963–2 CB 129, 137). However, only the portion of the expenses which are "directly related" to the active conduct of the taxpayer's trade or business are deductible. Thus, the use of the facility in providing entertainment "associated with" the active conduct of a trade or business is taken into account in determining if the facility is primarily used for business purposes but only those expenses attributable to a use which is "directly related" to the active conduct of a trade or business are deductible. For example, if 60 percent of the use of a yacht is for business entertaining but only 45 percent of the use satisfied the "directly related" test, only 45 percent of the facility expenditures would be deductible.

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[1] While dues or fees paid to any social, athletic, or sporting club or organization are considered to be expenses incurred with respect to an entertainment facility, clubs operated solely to provide lunches under circumstances generally considered to be conducive to business discussions are exempted. Treas. Regs. § 1.274–2 (e)(3)(ii). In addition, dues paid to professional associations and civic organizations generally are exempt. Rev. Rul. 63–144, 1963–2 C.B. 129, 138–139. An initiation or similar fee which is payable only upon joining a club, and the useful life of which extends over more than one year, is a nondeductible capital expenditure. *Kenneth D. Smith*, 24 TCM 899 (1965).

Background

In 1961, President Kennedy proposed the elimination of all income tax deductions for expenses for entertainment activities and facilities[2]. Congress responded to the President's 1961 proposals in the Revenue Act of 1962,[3] by enacting the basic provisions of present law.

The Congress concluded that additional restrictions should be imposed on entertainment deductions to deal with abuses of the tax law but that the complete disallowance of these expenses would not be a proper solution.[4] The Senate report stated that "expenses incurred for valid business purposes should not be discouraged since such expenses serve to increase business income, which in turn produces additional tax revenues for the Treasury." The Senate report also indicated concern that a large number of unskilled workers in the entertainment industry would find it difficult to find other employment if the disallowance of entertainment expenses created considerable unemployment in this industry.

Administration Proposal

Generally, the Administration proposal would disallow deductions for entertainment expenses which are not taxed to the recipient as compensation. For purposes of the proposal, the term "entertainment" would have the same meaning as under present law (except that special rules are recommended for business entertainment meals).

Effective date

The Administration proposal would be effective for tax years beginning after December 31, 1978.

Revenue effect

It is estimated that this proposal would increase calendar year liabillty by 420 million in 1979, by 459 milllon in 1980, 503 million in 1981, 551 milllon in 1982, and 602 million ln 1983.

Issues

The Administration argues that present law treatment of entertainment expenses is an open invitation to many taxpayers, who are generally in the upper-income levels, to charge personal expenses to the Treasury. In addition, the Administration argues that the provisions of present law make effective administration of the tax laws extremely difficult and uniform administration virtually unattainable. The Administration states that the proposal will reduce the unfairness, abuse, and administrative problems under present law.

The Administration argues that unfairness and abuse results under present law because entertainment deductions are allowed for expenses that are essentially for the personal benefit and enjoyment of individuals who do not include any amounts in income as a result of the expenditures. Because the rules under present law are said to be generous, complex, and subjectively applied by taxpayers, it is also argued that there is a tendency to claim questionable items and thereby engage in a "tax lottery" in the possibility of not being selected for

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[2] *See* President's Message, Hearings Before the House Ways and Means Committee, 87th Cong. 1st Sess. 43–44 (1961).

[3] *See* H.R. Rep. No. 1447, 87th Cong. 2d Sess. 19 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 24 (1962).

[4] *Supra* note 3.

audit or to test the outer boundaries for deductibility. It is further argued that personal benefits of entertainment deductions accrue largely to upper-income taxpayers.

On the other hand, others argue that business entertaining is customary and, in a competitive marketplace, is necessary to obtain new business or continue an existing business relationship. Thus, it is argued that expenses for business entertaining are legitimate and necessary costs of doing business. As such, it is argued that the allowance of deductions for entertainment expenses does not result in allowing deductions for purely personal expenses and results in no unfairness to other taxpayers because it is equitable to base an income tax on net income determined after the allowance of deductions for the costs of earning the income. As a cost of doing business, it may be argued that it is immaterial that upper-income taxpayers may more often claim entertainment deductions since progressivity should be maintained through the rate schedules rather than by special treatment of deductions. It is also argued that, if purely personal expenses are in fact being claimed by taxpayers, a substantial portion of the problem can be resolved by a more effective audit program and by providing greater guidance through rulings or the regulations.[5]

The Administration argues that even though entertainment may be a cost of doing business, it still provides the participant with benefits that would be paid for by others out of after-tax income. It argues that the disallowance of a deduction is needed to compensate for the failure to tax the participants on the benefits obtained. It argues that many taxpayers are able to claim a substantial portion of living expenses on a tax-deductible basis. Moreover, the Administration states that no specific suggestions have been made on how more effective auditing is to be accomplished to disallow deductions for personal expenses. It argues that distinguishing between personal and business purposes for entertainment involves a subjective determination of motive and may be a particularly sensitive question for Internal Revenue agents to press harder on than they now do.

The Administration states that its proposal will not hurt American business. It also argues that the proposed changes will be beneficial in terms of economic efficiency because there would be no tax "subsidy" for items such as yachts, theater and sports tickets, and country club memberships. The Administration states that output and employment in the economy as a whole will not decline as a result of the Administration proposal. It also contends that its proposal will not have a substantial effect on the entertainment industry.

On the other hand, others argue that the proposal will adversely affect the industries providing entertainment and entertainment facilities.

The committee may wish to consider limitations or disallowance rules for amounts paid for sports and theater tickets separately from its consideration of other types of entertainment activities. In general, these activities involve expenditures which are "associated with"

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[5] In addition to the general delegation of power to prescribe regulations under section 7805(b), specific regulatory authority is granted to the Secretary of the Treasury under section 274(i) to prescribe such regulations as he may deem necessary to carry out the purposes of the special disallowance rules of entertainment expenses.

the active conduct of a trade or business rather than those which are "directly related" to it. It may be argued that separate treatment is justified because these activities are more clearly personal and recreational in nature. Further, it might be argued that the furnishing of tickets to sporting and theater events is somewhat analogous to making a business gift. Under this reasoning, it might be appropriate to impose dollar limitations for the value of tickets furnished to an individual similar to the dollar limitations imposed upon business gifts.[6] For example, the committee may wish to consider a dollar limitation under which no more than a stated amount could be deductible for tickets given to any individual during a taxable year. Under present law, the dollar limitation established in 1962 for business gifts is $25.

Alternatively, the committee may wish to consider limitations or disallowance rules only for "box seat" arrangements under which accommodations beyond seating accommodations are furnished. Under some of these arrangements, the accommodations furnished may include a bar, kitchen, closed-circuit television, and telephone facilities. The annual rent or cost of these facilities may be substantial or a substantial one-time payment may be required with annual assessments made for maintenance costs. It may be argued that entertainment expenditures of this nature are not ordinary or necessary business expenses and may be lavish and extravagant in amount under present law. If so, the major effect of any legislation might be to provide more definitive rules to minimize audit controversy.

If the committee should consider separate treatment for theater and sports tickets, it is possible that there may be economic concerns extending beyond those generally involved in connection with the treatment of all entertainment expenses. For example, many of these types of events are held in municipally-owned facilities which might be adversely affected if sports and theater events were singled out for separate treatment.

Separately from its consideration of entertainment activities, the committee may wish to consider limitations or disallowance rules for the expenses of certain entertainment facilities, such as yachts, hunting lodges, apartments, and country clubs. In general, it could be argued that these expenses should be treated separately because they are more clearly personal and recreational in nature. It might also be argued that only facilities owned by, or under long-term lease to, the taxpayer should be subject to special limitations or disallowance rules and that day-to-day charters and rentals for yachts and lodges should be allowed as an out-of-pocket entertainment expense. In this way, the amount of entertainment expenses might be decreased because the depreciation and operating costs for the time a facility is not being used would not be allocated to the business use. Alternatively, the committee may wish to provide that the expenses allocable to business use would be determined by comparing use directly related to the active conduct of a trade or business to the total time "available for

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[6] Tickets to theater or sporting events may be treated as an entertainment expense or a business gift if the provider does not accompany a customer to the event. However, if the provider does accompany the customer, the cost of the tickets must be treated as an entertainment expense (Rev. Rul. 63–144, 1963–2 CB 129).

use" rather than the total time actually used for all purposes. This approach would possibly result in inequities where there was little personal use since all down or idle time would be allocated to personal use. However, it would tend to equalize amounts deductible for owned or leased facilities with amounts which would be deductible for day-to-day rentals for specific entertainment activities. Finally the committee might wish to consider limiting the depreciation deductions for a facility used primarily by the taxpayer for entertainment purposes to the straight-line method, or providing that a facility such as a yacht would not be eligible for the investment tax credit. Under the Administration's proposal relating to real property depreciation, depreciation for real property used as an entertainment facility, such as a hunting lodge, would be limited to the straight-line method. The committee might wish to consider applying this restriction to personal property used as an entertainment facility, such as a yacht. Under any of these alternatives, the same arguments against a general disallowance of entertainment expenses could be made against the alternative approaches.

Simplification and administrative aspects

The Administration feels that adoption of the proposal would ease administrative problems and contribute toward simplification of the tax laws. The proposal could eliminate recordkeeping burdens for entertainment expenses and eliminate the need to make interpretations of difficult terms, such as "directly related," "associated with," and "entertainment facilities." On the other hand, others argue that administrative problems and complexity do not justify the complete disallowance of legitimate costs of doing business.

B. Business Entertainment Meals

Present Law

Under present law, a deduction for business meals is allowed to the extent that the expenditures are ordinary and necessary expenses of the taxpayer's trade, business, or income producing activities. However, deductions for these expenditures are not allowed to the extent they are extravagant or lavish or are not adequately substantiated.

Expenses for meals while away from home in the pursuit of a trade or business are generally deductible under these rules. However, business "entertainment" meals, if otherwise allowable as deductions,[1] must meet certain additional requirements to avoid disallowance. In general, the cost of food and beverages furnished to an individual may be allowed as a deduction if they are furnished under circumstances generally conducive to business discussions, taking into account the surroundings in which furnished, the taxpayer's trade, business, or income producing activities, and the business relationship of the individual to whom the food or beverages are provided. There is no requirement that a business discussion actually take place.

The surroundings in which the food or beverages are furnished must provide an atmosphere where there are no substantial distractions. If substantial distractions not conducive to business discussions are present, for example, such as might be found in night clubs and sporting events, expenditures for food and beverage would have to meet the "directly related to" or "associated with" tests previously described in order to be allowable as an entertainment deduction.

The business relationship of the individual to whom food and beverage is provided must be such that the primary purpose for the expenditure is the furtherance of the taxpayer's trade, business or income producing activities and not primarily a social or personal purpose. Thus, where business associates or acquaintances are hosted by the taxpayer at an event the primary purpose of which is social or personal rather than related to the taxpayer's trade, business or income producing activity such expenditures would not be allowable as a deductible item.

Background

In 1961, the Administration proposed the elimination of all income tax deductions for entertainment activities and facilities. As an exception to the general disallowance of deductions for expenditures for foods and beverages, it was proposed that the cost of food and beverages consumed in the course of conducting business would be limited to a fixed amount per day for each individual involved. The suggested limitation was from $4 to $7. Another exception was proposed to cover the cost of food or beverages provided primarily to employees on business premises.

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[1] Code sec. 274 is a disallowance provision. Expenses for entertainment, amusement, or recreation must be otherwise allowable as a deduction under the Code, for example, Code secs. 162 and 212, pertaining to expenses paid or incurred in connection with a taxpayer's trade or business or income-producing activities, respectively, and meet the requirements of Code sec. 274 to avoid disallowance as a deduction.

With respect to business entertainment meals, the Congress responded to this proposal by enacting the provisions of present law in the Revenue Act of 1962.

Administration Proposal

Under the Administration proposal, only 50 percent of the cost of a business meal would be deductible. Dues of fees paid to clubs operated solely to provide business lunches would also be allowed only to the extent of 50 percent of the cost of the dues of fees.

The Administration does not propose any change in the treatment of expenses incurred for meals and lodging for a taxpayer who is away from home overnigh in pursuit of a trade, business or other income producing activity. In addition, an exception is proposed for meals provided to an employee for the convenience of the employer if the value of the meals is excludable from income by the employee. However, if the value of such means are includible in the employee's gross income, the expense of employer facilities used primarily to provide the meals to those employees would be subject to the 50-percent disallowance rule.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this proposal would increase calendar year liability by 884 million in 1979, by 970 million in 1980, 1,063 million in 1981, 1,162 million in 1982, and 1,274 million in 1983.

Member's Proposal

Mr. Fisher

Mr. Fisher favors the Administration proposal. However, if the committee does not adopt it, he proposes to limit the amount deductible to a specifically stated amount. For each person participating in a business meal, he suggests a limitation of from $4 to $7 per meal.

Issues

The Administration proposes to disallow 50 percent of the currently deductible entertainment expenses for food and beverages. It reasons that, regardless of the existence of a business purpose, the high level of personal value associated with entertainment justifies the proposed disallowance of deductions. The Administration argues that the present law requirements are easily satisfied and permit the deduction of expenses which are essentially personal. Disallowance, therefore, would be required to achieve the equivalent of including in the tax base the personal value of the benefit to the recipient.

The 50-percent disallowance figure was selected because it is roughly the equivalent, in terms of tax revenue, to allowing a full deduction to the payor, and including half of the total cost in the income of the recipients.

It has been argued that the restaurant industry will be adversely affected by the Administration's proposal. The Administration contends that its proposal will not have a substantial effect on that industry. The Administration estimates that the total employment reduction in the restaurant industry will not exceed 2 percent, and that the rapid employment turnover in that industry will absorb much of

any employment reduction. One analysis concluded that, since the restaurant industry has been growing faster than other segments of the economy, jobs in that industry might be expected to grow faster than the average for the rest of the economy but that the growth differential will be smaller than it otherwise would be if the Administration's proposal is adopted.[2]

Simplification and administrative aspects

The Administration's proposal would not have a significant impact in terms of tax complexity for the treatment of business entertainment meals generally. It would introduce a separate computation to calculate the 50-percent amount allowable. In order to apply the percentage limitation, the same definitional recordkeeping and substantiation complexities under present law would continue to arise in determining the amount to which the limitation applied. In several situations, recordkeeping burdens may be increased. For example, it might be necessary to keep more detailed records to indicate if any of the persons are in a travel status. If so, a calculation must then be made to apportion the cost of the meal and determine the amount that is fully deductible as a travel meal and the amount allowable as a deduction for an entertainment meal.

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[2] Jane Gravelle, "The Proposed Curtailment of the Deduction for Business Expenses: General Issues and the Employment Impact in the Restaurant Industry", Congressional Research Service, printed in the Cong. Rec. S. 2424 (daily ed. February 27, 1978).

C. Travel Expenses

Present Law

Away from home travel expenses, including the cost of first class airfare, are generally deductible if they are paid or incurred during the taxable year in connection with the taxpayer's trade or business, or in pursuit of a nonbusiness activity engaged in for profit. If a trip is related primarily to the taxpayer's business, transportation expenses are deductible even though the taxpayer engages in some nonbusiness activities during the course of the trip. Conversely, if the trip is primarily nonbusiness in nature, then no amount of the transportation expenses are deductible even if the taxpayer engages in some business activity during the trip. However, business expenses incurred during the course of a primarily nonbusiness trip are deductible if they otherwise meet the applicable requirements for deductibility. In general, the same substantiation rules which are applicable in the case of entertainment expenses apply to travel expenses.

As described below (part D), special rules apply to foreign business travel and to foreign conventions.

Background

In 1961, President Kennedy proposed to limit deductible business travel expenses to amounts which were reasonable, and neither lavish nor extravagant. Where a business trip was combined with nonbusiness purposes, the 1961 proposal would have disallowed a portion of the cost of travel to and from the business destination as an income tax deduction. The Revenue Act of 1962 provided that lavish or extravagant expenditures for meals and lodging during business travel were not deductible. In addition, as originally enacted in 1962, an allocation of all domestic and foreign business travel costs between business and personal expenses was generally required. No allocation was required if the trip was one week or less in duration, or if the personal portion of the travel did not exceed 25 percent of the time away from home. In 1964, the Congress repealed the allocation requirement for domestic, but not foreign, business travel expenses. In 1976, the Congress imposed a coach fare limitation on deductible airfare paid or incurred to attend a foreign convention.

Administration Proposal

The Administration proposal would disallow business deductions for the portion of air fare attributable to first class, but would continue to allow deductions for that part of the first class fare which is equal to coach fare. Specifically, the Administration's proposal would disallow deductions for costs of regularly scheduled, commercial air transportation to the extent that they exceed the amount of the lowest priced, generally available fare for regularly scheduled flights between the same points at the same time of day. A fare would not be considered to be "generally available" if it is available only to those who fly on

stand-by status, purchase tickets at a specified period of time in advance of the flight, or stay at their destination a specified period of time. The deductibility of costs of air transportation which is noncommercial or not regularly scheduled would not be affected by this proposal, e.g., air charter or private aircraft.

This proposal would apply to all currently deductible costs of regularly scheduled, commercial air transportation incurred in connection with the taxpayer's own business travel (including, as under present law, travel to attend foreign conventions). Under the Administration's separate proposal on deductibility of entertainment expenses, the full amount of any transportation expenses incurred in connection with a trip whose sole purpose is to entertain the traveler would be disallowed.

Where first class air fare is furnished to an employee by his employer, a deduction for the portion of the fare attributable to first class would be disallowed to either the employer or the employee, but not both. If amounts paid by an employer are treated as compensation to an employer, the limitation would not apply to the employer. Similar rules would apply to payments made to or for the benefit of independent contractors.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this proposal would increase calendar year liability by 149 million in 1979, by 156 million in 1980, 164 million in 1981, 172 million in 1982, and 181 million in 1983.

Issues

The Administration argues that, for most people, first class air fare is a luxury. It argues that the primary difference between a first class seat and a coach seat on an airplane is a personal indulgence. It argues that there is generally no business necessity for first class air travel. The Administration believes that the allowance of deductions for the full amount of first class air fare provides a tax subsidy for first class travel.

On the other hand, it has been argued that there is frequently a need for airborne working space, and, therefore, the extra cost for than merely a "luxury" cost. Accordingly, if the extra airfare for first class accommodations is appropriate in certain cases, it may be argued that the Administration's proposal is simply a deduction limitation based on the minimum amount for which a service can be purchased. As such, it may be argued that logic requires that no differentation be made between airfare and any other business expenditure for goods and services.

Another consideration which the committee may want to review in analyzing this proposal is its potential effect on the airline industry and its employees. While the major effect of this proposal may be to cause a shift in demand among business travelers using commercial airlines from first class to coach seating, it also may cause some business travelers who presently use first class travel to shift from commercial airlines to privately-owned aircraft or to other forms of transportation.

The committee may also wish to consider whether it is appropriate to limit deductible air transportation costs but not to apply similar limitations to other types of transportation.

Simplification and administrative aspects

The Administration's proposal would require taxpayers who fly first class to ascertain the lowest-priced generally available fare for regularly-scheduled flights and to compute the amount of excess fares. Recordkeeping and substantiation burdens would be increased to some extent by these requirements.

In one limited situation, the proposal would simplify recordkeeping and the determination of deductible air travel costs. This situation involves travel to a foreign convention involving both domestic and foreign air travel. Under present law, the foreign travel is subject to a coach fare limitation but the domestic travel is not so limited. Under the Administration's proposal, there would be consistent treatment for domestic and foreign air travel.

D. Foreign Convention Expenses

Present Law

Prior to the Tax Reform Act of 1976, a deduction was allowed for traveling expenses paid or incurred to attend a foreign convention if the traveling expenses were reasonable and necessary in, and directly attributable to, the conduct of the taxpayer's trade or business.

The 1976 Act provided specific rules (sec. 274(h)) limiting the deduction for expenses of attending conventions, seminars or similar meetings held outside the United States, its possessions, and the Trust Territory of the Pacific. These rules apply not only to the individual attending the convention, but also to an employer who pays the expenses. Under these rules:

1. No deduction is allowed for expenses paid or incurred by an individual in attending more than two foreign conventions in any taxable year.

2. With respect to the two conventions for which a deduction is allowable, the amount of expenses that can be deducted for transportation and subsistence are limited. A deduction for transportation expenses outside the United States may not exceed the coach or economy rates charged by a commercial airline. The deduction for subsistence may not exceed the dollar per diem rate established for federal employees at the location in which the convention is held.

3. No deduction is allowed for subsistence expenses unless (a) a full day or half day of business activities are scheduled on each day during the convention, and (b) the individual attends at least two-thirds of the hours of the daily scheduled business activities or, in the aggregate, attends at least two-thirds of the total hours of scheduled business activities at the convention.

4. The taxpayer must comply with certain reporting requirements. For example, information must be furnished to indicate the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day devoted to business activities (in a brochure describing the convention, if available), and any other information required by regulations. In addition, the taxpayer must attach a statement to his income tax return, signed by an appropriate officer of the sponsoring organization, which must include a schedule of the business activities of each convention day, the number of hourly-related activities that the taxpayer attended each day, and any other information required by regulations.

5. A deduction for the full amount of expenses of transportation (subject to the coach or economy rate limitation) to and from the site of a foreign convention is allowable only if one-half or more of the total days of the trip are devoted to business-related activities. In determining whether a day is devoted to business-related activities, the same rules for counting full days and half-days for purposes of subsistence expenses are applied.

Background

Law prior to 1976 Tax Reform Act

Under the law prior to the Tax Reform Act of 1976, the deductibility of traveling expenses paid or incurred to attend a foreign convention, seminar, or similar meeting while away from home was governed by the ordinary and necessary standard for business and investment expenses (secs. 162 and 212) and, in certain cases, special disallowance rules relating generally to foreign travel during which a taxpayer engages in both business and nonbusiness activities (sec. 274(c)).

With respect to expenses incurred in attending a convention or other meeting, the test for deductibility as trade or business expenses is whether there is a sufficient relationship between the taxpayer's trade or business and his attendance so that he is benefiting or advancing the interests of his trade or business. Generally, deductibility depends upon the facts and circumstances of each particular case. If the convention is for political, social, or other purposes unrelated to the taxpayer's business, the travel expenses are not deductible. The Internal Revenue Service had ruled that the test for allowance of deductions for convention expenses is met if the agenda of the convention or other meeting is so related to the taxpayer's position as to show that attendance was for business purposes. (Rev. Rul. 63–266, 1963–2 C.B. 88).

Generally, if a trip is primarily made for business purposes, travel expenses are deductible in full, except for additional expenses incurred with respect to personal activities during the trip. Thus, transportation expenses for a trip made primarily for business purposes are generally deductible in full although the taxpayer may engage in some personal activities during the trip. However, an allocation of costs, including transportation costs, to the personal or nonbusiness activities is required for certain foreign travel (sec. 274(c)). This allocation rule applies if the foreign travel is for more than one week and the foreign travel attributable to nonbusiness activities is 25 percent or more of the total time of the travel. In the case of foreign travel to which this provision applies, the portion of the travel expenses allocated to the nonbusiness activities is not deductible. The allocation is made on the basis of nonbusiness days compared to total days of travel.

Prior congressional action

1974 committee bill

In 1974 during a markup of a tax bill which was not reported, the Ways and Means Committee tentatively decided to limit deductions allowable for the expenses of taxpayers attending conventions, educational seminars or similar meetings outside North America. The general rule tentatively agreed to by the committee was that no deduction would be allowable for foreign travel expenses (including expenses for transportation, meals and lodging) for an individual with respect to a convention, seminar or similar meeting held outside North America unless, taking into account certain factors, it was more reasonable to hold the meeting outside the North American area than within that area. North America was defined to include the Caribbean.

Under this rule, deductions for a meeting conducted by an organization which had foreign members would not have been disallowed to the extent the number and location of its foreign meetings were reasonable in light of the number of foreign members and their geographical dispersion. Existing law relating to the allocation of expenses was to continue to apply to any case where the travel expenses attributable to foreign meetings were still deductible.

The rule also was not intended to disallow deductions for the expenses incurred in attending a convention, etc., at a location that was uniquely suited to the purposes of the convention, provided that the attendance at the conference by an individual was related to his trade or business. Thus, a deduction would have been allowed in the case of an individual who attended a meeting conducted or sponsored by a domestic organization which met outside North America if there was a compelling reason for meeting outside North America taking into account the membership and purpose of the organization.

1976 Tax Reform Act

In 1975, as part of the tax reform bill, the Ways and Means Committee reported out a provision limiting the deduction for attendance at foreign conventions. That provision was similar to the provision as finally enacted in the Tax Reform Act of 1976, except that the bill also limited the airline fare to coach fare for the portion of travel within the United States to a foreign convention, and the bill did not contain the reporting requirements.

The Senate amendments to the bill deleted the House provisions and added one provision which was similar to the provision tentatively agreed to by the Ways and Means Committee during its 1974 markup. That Senate amendment denied deductions for conventions outside the North American area unless it was more reasonable to hold the convention outside the area than within. Also under that amendment, no deduction was allowed for a convention held on a cruise ship. The Senate also adopted a floor amendment under which no change would have been made with respect to foreign conventions.

The conference committee agreed to the House provisions but allowed a deduction for the cost of first-class airfare within the United States and added the specific reporting requirements.

Administration Proposal

Under the Administration proposal, expenses of attending a foreign convention would be deductible only if it is as reasonable to hold the convention outside the United States and possessions as within. The factors to be considered in determining reasonableness of convention site are the purpose and activities of the convention, the purpose and activities of the sponsoring organization, the residence of active members of the sponsoring organization, the places at which other conventions of the sponsoring organization have been held, and the particular reason(s) why the convention is being held abroad rather than in the United States or its possessions. For conventions satisfying

this test, deductible subsistence expenses could not exceed 125 percent of the Federal per diem for the convention site. (The Administration proposal would replace the limitations enacted in 1976, except that deductible air fare would be limited to coach fare under the generally applicable proposed rule described above.)

The detailed attendance rules under present law would not be continued.

Effective date

The Administration proposal would be effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will have a negligible revenue effect.

Member's Proposals

Mr. Waggonner

Mr. Waggonner proposes to delete the Administration proposal. Instead, he proposes to modify present law in several respects. Under his proposal, the special foreign convention rules would apply to conventions held outside the "North American" area instead of outside the United States. In addition, he proposes the repeal of the existing per diem limitation on subsistence expenses. Finally, he proposes to redefine the term "convention" to ensure that the special foreign convention rules apply only to those types of "meetings" intended to be covered by the 1976 Act.

Mr. Gephardt

Mr. Gephardt's amendment would make clear that any changes in present law relating to the deductibility of travel, entertainment or foreign convention expenses will not apply to an employer or other person paying such expenses to the extent that such expenses are includible in the gross income of an employee or other person for whom the payments were made unless the payor fails to treat such payments as so includible for purposes of an applicable information return required to be filed by the payor.

Issues

The basic issue raised by the Administration's proposal is whether there should be limitations on the deductibility of expenses paid to attend foreign conventions.

The Administration is concerned that the 1976 Act does not eliminate the abuse it was designed to eliminate, i.e., the tax-paid foreign vacation. In addition, the Administration argues that the provisions enacted in 1976 are unduly complex for taxpayers and the Service.

Under the Administration proposal, it appears likely that there may be a reduction in foreign conventions held in resort areas where the vacation aspects of the convention are a major aspect of the

convention. On the other hand, some additional conventions may be held abroad when it is reasonable to do so, because deductibility of the expenses would not depend on how many other foreign conventions the possible attendees may also attend.

Simplification and administrative aspects

Under a reasonableness test, the allowability of deductions for foreign convention expenses would depend upon the facts and circumstances of a particular case. Although factors could be set forth for objective application to various situations, a reasonableness test might not provide the same degree of certainty as is provided under the "two convention" rule.

On the other hand, under the Administration's proposal, the detailed attendance recordkeeping requirements would be eliminated. This part of the proposal would simplify the law for convention sponsors and the attendees.

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