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THE MISSOURI RULE—SUBSTANTIATION REQUIREMENTS FOR TRAVEL AND ENTERTAINMENT EXPENDITURES UNDER SECTION 274(d) OF THE INTERNAL REVENUE CODE OF 1954

CLAUDE L. EICHEL*

"I'm from Missouri; you must show me."
—ascribed to Willard D. Vandiver.¹

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1. The expression was first heard generally in the presidential campaign of 1912, when Champ Clark of Missouri was a Democratic candidate. MENCKEN, A NEW DICTIONARY OF QUOTATIONS ON HISTORICAL PRINCIPLES FROM ANCIENT AND MODERN SOURCES. 796 (1960).

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I. INTRODUCTION

The purpose of this article is to examine the substantiation requirements imposed by the Revenue Act of 1962 on persons who claim income tax deductions for expenditures relating to travel, entertainment, and gifts.

The second session of the eighty-seventh Congress enacted Public Law 87-834, commonly known as the Revenue Act of 1962.² One of the stated purposes of the act was "to eliminate certain defects and inequities."³

Section 4 of the act added section 274 to the Internal Revenue Code of 1954.⁴ This section is entitled: "Disallowance of Certain Entertainment, Etc., Expenses," and provides for substantive limitations relating to deductions for travel and entertainment expenses, and gifts. In addition, subsection (d) provides for certain substantiation (procedural) requirements to be met in order to obtain a deduction for *any* travel, entertainment, or gift expenditures.⁵

The new *substantive*⁶ requirements will eliminate⁷ such abuses as travel and entertainment deductions claimed for expenses incurred with regard to yachts, safaris to Africa,⁸ and the like, but these items are not claimed by most taxpayers. Most businesses, however, claim *some* deduction for travel, entertainment, or gift expenditures, and will therefore, be greatly affected by the new substantiation requirements. As a result, the sole inquiry in this article will be as to these requirements.

It should be noted that section 274 is a disallowance provision exclusively. No new expenses have been introduced into the deductible category by reason of its enactment. The tests for deductibility under other provisions of the code⁹ must still first be met before the limitation provisions of section 274 need be considered.¹⁰

2. 76 Stat. 960 (1962).

3. *Ibid.*

4. All further reference to section will be to the Internal Revenue Code of 1954 unless otherwise indicated.

5. Sen. Fin. Rep., p. 173.

6. Sections 274(a), (b), (c).

7. Sen. Fin. Rep., p. 28.

8. Sanitary Farms Dairy, Inc., 25 T.C. 463 (1955).

9. *E.g.*, §§ 162, 165, 167 & 212.

10. Sen. Fin. Rep., p. 169.

A. *Why the Change?*

The primary reason for enactment of the new travel and entertainment section was the desire of Congress to strengthen enforcement in an area where widespread abuses were evident.

The Treasury Department had brought to the attention of Congress these widespread abuses that had developed through the use of the expense account. In the President's 1961 tax message, business entertainment expenses and the maintenance cost of business entertainment facilities were requested to be disallowed in full as tax deductions and that restrictions be imposed on the deductibility of business gifts and travel expenses.¹¹ The President reaffirmed his position in the 1962 budget message,¹² and again in his economic report.¹³ Congress was unwilling to go that far. It felt that if valid business expenses were to be disallowed as a deduction, there might be a substantial loss of revenue where business transactions are discouraged, or where they fail to be consummated.¹⁴ The creation of unemployment in the entertainment industry was also cited as a probable result¹⁵ of the disallowance.¹⁶

Congress *did*, however, place restrictions on the deductibility of travel, entertainment, and gifts, both substantively¹⁷ and as to the manner of proof required to support the expenditures.¹⁸ Substantive changes in the law are not unusual. They have been a concomitant of the revenue laws since their inception, and have sought to clarify and expand existing law to reflect the political, economic, and sociological climate of the times. On the other hand, the revenue laws rarely enumerated elements of proof, since guideposts have always been available through the established body of evidentiary law that has evolved through the centuries. In addition to being governed by these general principles, since 1930, income tax jurisprudence has been guided in the area of substantiation, by an evidentiary rule propounded by an eminent jurist in the course of resolving an income tax dispute involving a famed showman.¹⁹ This rule, known as the *Cohan* rule, has governed the deduction of travel and entertainment expenses for more than three decades.

Because it was the intent of Congress in passing section 274(d)

11. 1 U.S. CODE CONG. & AD. NEWS 1136 (1961).

12. 2 U.S. CODE CONG. & AD. NEWS 4063 (1962).

13. *Id.* at 4083.

14. Sen. Fin. Rep., p. 25.

15. *Ibid.*

16. The Treasury Department estimates that had the President's proposals as to expense account abuses been adopted without qualification, the revenue gain would have amounted to \$250,000,000. Under § 274 as enacted, the Treasury Department estimates the revenue gain to be \$60,000,000. 2 U.S. CODE CONG. & AD. NEWS 3691 (1962).

17. Sections 274(a), (b), & (c).

18. Section 274(d).

19. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) (Judge Learned Hand).

specifically to override the *Cohan* rule,²⁰ it becomes material to discuss the rule, and the effect it has had on the tax world.

B. *George M. Cohan*

1. YANKEE DOODLE

George M. Cohan was a showman whose career stretched from the 1890's to the 1940's. During that time, he became a beloved part of the American scene, the man who's name epitomized Broadway. He won a congressional award for writing "Over There," the soldier's song of World War I.²¹ He was a playwright, song writer, play doctor, stage director, actor, dancer, and producer.²² All of these occupations brought him substantial income, and left him little time to keep records (assuming that he would have had an inclination to do so if he did have time). No one would have wanted Cohan to add the occupation of bookkeeper to those which gave him world-wide fame—that is, no one except the Internal Revenue agent who was skeptical of deductions Mr. Cohan took for travel and entertainment on his tax returns. This divergence of views as to record keeping was one factor responsible for bringing George M. Cohan to the unfamiliar stage of the Board of Tax Appeals.²³

2. THE COHAN RULE

From early 1921 to the middle of 1923, Cohan produced or acted in no less than eight Broadway shows.²⁴ As a playwright and a famous actor, he was obliged to be freehanded in entertaining actors, employees, and drama critics. He also travelled extensively, sometimes with his attorney. He spent a great deal of money in this manner, but kept no accounts or records. When he testified before the Board of Tax Appeals, he estimated that he had spent at least 11,000 dollars on travel and entertainment in the first half of 1921, 22,000 dollars in the following twelve months, and a like sum for the following fiscal year. The Board, however, refused to allow him *anything* for travel and entertainment deductions for the periods involved, on the ground that it was impossible to ascertain the amount expended in the absence of any items or details:

We can not doubt, upon the record, that [Mr. Cohan] . . . was required to and did spend large sums of money in traveling and entertaining. . . . There are, however, two obstacles . . . to overcome. One is that the amounts claimed are bare estimates unsupported by any vouchers or bookkeeping entries of any kind. The other is that we do not know what part of the amounts expended were for personal expenses. In these circum-

20. Sen. Fin. Rep., pp. 25, 173.

21. MOREHOUSE, *GEORGE M. COHAN, PRINCE OF THE AMERICAN THEATRE* (1943).

22. *Ibid.*

23. *George M. Cohan*, 11 B.T.A. 743 (1928).

24. MOREHOUSE, *op. cit. supra* note 21.

stances we can not say that the [Commissioner] . . . erred in disallowing the deductions claimed.²⁵

On appeal, Cohan found a sympathetic ear in the person of Judge Learned Hand. In reversing the Board of Tax Appeals, speaking for the court, Judge Hand held that estimates were allowable:

Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent It is not fatal that the result will inevitably be speculative; many important decisions must be such.²⁶

Thus was born the *Cohan* rule, a standard applied to travel and entertainment expenses, as well as to other areas, until the Revenue Act of 1962 legislated the rule out of existence in the travel and entertainment expense area.

3. ABUSE

By 1962, taxpayers, the courts, and the Internal Revenue Service,²⁷ had come to make free use of the *Cohan* rule. While most taxpayers avowedly claimed only amounts actually spent,²⁸ the rule provided a great temptation to taxpayers to over-estimate expense account items in the expectation that when the Internal Revenue agent finished disallowing expenses in part, under the rule, the taxpayers would end up with satisfactory deductions. In some cases, they probably would have been allowed more than if they had kept accurate records.²⁹

The absence of any fixed standards of substantiation, as a practical matter (because of excessive deductions), resulted in the shifting of the burden of proof from the taxpayer to the government. This posed an enormous administrative problem for the Internal Revenue Service. Because of *Cohan*, the government knew that they would have to allow the taxpayer something; the question was, how much? The same lack of objective standards made it impossible to gauge accurately the result

25. George M. Cohan, 11 B.T.A. 743, 761 (1928).

26. *Cohan v. Commissioner*, 39 F.2d 540, 543 (2d Cir. 1930).

27. For purposes of this article, the terms "government," "Commissioner," "Internal Revenue Service," "Service," "District Director," and "Director," will be used interchangeably.

28. "When there is an income tax, the just man will pay more and the unjust less on the same amount of income." PLATO, *THE REPUBLIC*, Book 1, 342-D (427-347 B.C.), as quoted in 6 *RUTGERS L. REV.* 375 (1952).

29. For discussions of the *Cohan* rule generally, see Gluck, *How Cohan Works: Allowance of Business Expense Deductions When No Exact Records Are Kept*, 6 *RUTGERS L. REV.* 375 (1952); Kramer, *Estimated Income and Expense in the Tax Law*, 32 *TAXES* 906 (1954); Cobert, *Criminal Consequences in Deducting Improper Expenses*. N.Y.U. 17TH *INST. ON FED. TAX.* 549 (1959).

of litigation, because the courts, at their discretion, could award more or less than had the Commissioner. The government was therefore faced with an impossible situation—in effect it had to prove that the taxpayer did not incur the claimed expenses. The shifting of the burden of proof to the government resulted in a feeling, among taxpayers generally, that businessmen were “getting away” with paying less than their share of taxes.

A tax system which relies upon each taxpayer to be his own tax assessor is jeopardized when resentment is caused by discrimination which allows some taxpayers to take unfair advantage of the laws.³⁰ This discrimination makes taxpayers resentful of the law which permits the situation to exist, and encourages them toward laxity in discharging their full tax obligations. As one commentator has stated:

Many a disgruntled citizen can be expected to withdraw his willing financial obeisance to a government which purposefully creates large loopholes so as to unjustifiably excuse large amounts of tax to some classes of its citizens. There is not much difference in blinking at the means by which others escape in practice by sloppy methods of administration and fuzzy judicial supervision. The business expense and entertainment deduction is one common evasion abuse which many people know about and avowedly set out to use.³¹

Senators Douglas and Gore described the situation as follows:

One of the best known and most resented special privilege in the tax law today is the deductible expense account. President Kennedy described this tax giveaway as “a matter of national concern.”

The allowance of deductions for such essentially personal entertainment has brought the integrity of the entire revenue system into disrepute. The expense account deduction has been a breeding ground for fraud and misrepresentation. It has encouraged disrespect for honest self-compliance with the tax laws among those not in a position to claim such deductions, but who have watched others satisfy their personal amusement at the taxpayers' expense.³²

30. Unfortunately, many if not most businessmen consider the maintenance of a diary or other adequate records too cumbersome. They tend to rely on estimates, checks drawn to cash without identification as to purpose, club statements, etc., to try to prove by oral argument or persuasion that a substantial amount was spent for entertainment and, therefore, most of the deduction should be allowed under the “Cohan Case.” Hemmings, *Deductions for the Individual Taxpayer*, 7 TUL. TAX INST. 614, 619 (1958).

31. Boehm, *Ordinary and Necessary Expenses: Proximate Relationship as a Rejuvenated Test for Deductibility*, 30 U. CINC. L. REV. 1, 23 (1961).

32. Supplemental and Minority Views of Senators Paul Douglas and Albert Gore, 2 U.S. CODE CONG. & AD. NEWS 3712 (1962).

Moreover, the absence of restrictions encourages taxpayers to ask: "Why should not I deduct my personal pleasures and entertainment, if everyone else can?"³³

4. ATTEMPTS TO CURB ABUSES

The general atmosphere engendered by these abuses led first the Revenue Service, then the courts, and finally Congress, to attempt to rectify the situation.

The Internal Revenue Service, in a 1960 ruling,³⁴ enumerated certain criteria as to what would constitute substantiation to an employer under the regulations³⁵ relieving an employee who has accounted³⁶ to his employer,³⁷ from the requirements of accounting to the Treasury Department for the amount of his expense allowances.³⁸ This ruling did not preclude application of the *Cohan* rule in allowing estimates by recipients of expense accounts. It merely required anyone not meeting the substantiation requirements of the ruling to subject himself to the scrutiny of the Internal Revenue Service, rather than to that of his employer alone.

In recent years, the Internal Revenue Service has instituted certain disclosure requirements on tax returns. Disclosure is required of the amount of payments, including expense allowances given to certain owners and highly compensated employees,³⁹ on partnership⁴⁰

33. See annotations, Rothschild and Soberheim, *Expense Accounts for Executives*, 67 YALE L.J. 1363 (1958).

34. Rev. Rul. 120, 1960-1 CUM. BULL. 83.

35. Treas. Reg. § 1.162-17(d) (1963).

36. Treas. Reg. § 1.162-17(b)(4) (1963): . . . To "account" to his employer . . . means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

For a similar provision under the new rules, see note 148 *infra*.

37. Rev. Rul. 120, 1960-1 CUM. BULL. 83, states that for purposes of Treas. Reg. § 1.162-17(b)(4), the employee must submit such detailed information as will enable the employer to determine whether the expenses claimed constitute ordinary and necessary business expenses incurred in connection with the performance of services as an employee.

38. In the case of traveling expenses, under Rev. Rul. 120, 1960-1 CUM. BULL. 83, 84, the employee must submit to his employer detailed information such as (1) the date and place of travel; (2) the cost of transportation; (3) the number of days away from home overnight; (4) an itemized statement showing total costs incurred for meals, lodging, and miscellaneous business expenses, such as cab fare, telephone, etc., and; (5) in connection with large or exceptional expenditures, supporting documents, such as receipts.

In the case of entertainment expenses, the ruling requires the employee to submit detailed information as will sufficiently identify the persons entertained (by name or title) to establish the business nature of the expenses, and will show the place, nature, and cost of the entertainment, and the reasons why it was necessary to incur the entertainment expense. These provisions are strikingly similar to the provisions under the new rules.

39. Corporations and partnerships must report all payments to the twenty-five highest paid officers and partners (including limited partners), with regard to compensation plus

and corporation⁴¹ returns, and on the "self-employment income" schedule of individual tax returns.⁴² In addition, individual returns ask the following question:

Did you receive an expense allowance or reimbursement, or charge expenses to your employer?

If so, did you submit itemized accounting of all such expenses to your employer?

These disclosure requirements have enabled the service to pin-point returns that may contain abuses in the expense account field. Failure to give the required information might be considered to be inconsistent with the jurat appearing on tax returns which indicates that to the best of the signer's knowledge, the return is a true and "complete" one.

Disclosure alone, however, did not solve the problem of abuse. For even where the service *did* find these abuses, they were still faced with the *Cohan* rule and its attendant burden of proof problem⁴³ previously mentioned.

The effect of the *Cohan* rule was modified somewhat by the Fifth Circuit in 1957, in the case of *Williams v. United States*,⁴⁴ where the court construed the *Cohan* rule to mean that a court *may* allow estimates, rather than that a court *must* allow estimates.⁴⁵

The *Cohan* rule has been distinguished on the basis that in the *Cohan* case, a *complete* disallowance of claimed deductions was involved. Therefore, some courts have refused to apply the rule where the Commissioner allowed *some* amount as a deduction.⁴⁶

expense allowances. Individuals must report the same information as to the proprietor and his five highest paid employees.

However, in no event is disclosure required for a corporate officer, partner, proprietor (or his employees), whose compensation plus the allowance is less than \$10,000. A partner's compensation includes his share of the partnership's ordinary income, even though not actually distributed to him. A proprietor's compensation is the net profit from his business or profession plus his expense allowances which were deducted in arriving at his net profit. T.I.R. No. 221, April 4, 1960.

40. Form 1065.

41. Form 1120.

42. Form 1040, Schedule C.

43. For burden of proof instructions to jury under the *Cohan* rule, see *Brooks v. United States*, 280 F.2d 370 (5th Cir. 1960).

44. 245 F.2d 559 (5th Cir. 1957).

45. That the trier . . . might have considerable latitude in making estimates of amounts probably spent in the light of accepted practice amongst law-abiding businessmen of moral standing considering the nature and kind of records which might reasonably be kept for such expenditures . . . certainly does not require that such latitude be employed. The . . . court may not be compelled to guess, or estimate Until the trier has that assurance from the record . . . [that *at least* the amount allowed was spent] . . . relief to the taxpayer would be unguided largesse. *Id.* at 560.

46. Reginald G. Hearn, 36 T.C. 672 (1961); Harrison A. Bennett, 19 P-H Tax Ct. Mem. 803 (1950); Donald W. Bolt, 16 P-H Tax. Ct. Mem. 1115 (1947).

Congress had not previously set any definite standards for deduction of travel and entertainment expenditures other than the general language of sections 162(a) and 212. Requirements for substantiation were delineated solely through Treasury Regulations and Revenue Rulings.⁴⁷

II. THE MISSOURI RULE

A. *In General*

The legislative answer to the abuses which had arisen through implementation of the *Cohan* rule was section 4 of the Internal Revenue Act of 1962, which added section 274(d) to the Internal Revenue Code of 1954. This section reads as follows:

Section 274. Disallowance of Certain Entertainment, etc. expenses.

(d). Substantiation Required.—No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts, unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of the persons entertained, using the facility, or receiving the gift. The Secretary, or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

The essential elements⁴⁸ which must be substantiated are:

1. Amount
2. Time
3. Place
4. Business Purpose
5. Business Relationship

47. The regulations under § 162 are still valid to the extent that they are not inconsistent with § 274(d). Treas. Reg. § 1.162-17(e) (1963).

48. Treas. Reg. § 1.274-5(b) (1963).

The main categories of type of expenditure to which the above elements apply are:

1. Travel⁴⁹
2. Entertainment⁵⁰ in general
3. Entertainment⁵¹ preceding or following a bona fide business discussion
4. Business Gifts

The chart that follows indicates the application of these elements to each type of expenditure.

49. The new rules apply only to travel while away from home. The record-keeping requirements of existing law continue to apply to expenses for local travel. Rev. Proc. 63-4(9), 1963 INT. REV. BULL. No. 4, at 25.

50. Treas. Reg. § 1.274-5(a) (1963). For purposes of § 274(d), entertainment means entertainment, amusement or recreation, and use of a facility therefore.

51. Treas. Reg. § 1.274-5(a) (1963). For purposes of § 274(d), expenditure includes expenses and items such as losses and depreciation.

52. Treas. Reg. § 1.274-5(b)(2)(i) (1963).

53. Treas. Reg. § 1.274-5(b)(3)(i) (1963).

54. Treas. Reg. § 1.274-5(b)(4) (1963).

55. Treas. Reg. § 1.274-5(b)(5)(i) (1963).

56. Treas. Reg. § 1.274-5(b)(2)(ii) (1963).

57. Section 274(c). See also Treas. Reg. § 1.274-5(b)(2)(iv) (1963).

58. Treas. Reg. § 1.274-5(b)(2) (1963).

59. Treas. Reg. § 1.274-5(b)(3)(ii) (1963).

60. Treas. Reg. § 1.274-5(b)(4)(i) (1963).

61. Treas. Reg. § 1.274-5(b)(5)(ii) (1963).

62. Treas. Reg. § 1.274-5(b)(2)(iii) (1963).

63. Treas. Reg. § 1.274-5(b)(3)(iii) (1963).

64. Treas. Reg. § 1.274-5(b)(4) (1963).

65. Treas. Reg. § 1.274-5(b)(3)(v) (1963).

66. Treas. Reg. § 1.274(b)(2)(iv) (1963).

67. Under § 274(e)(1), business meals are defined as expenses for food and beverages furnished to any individual under circumstances (taking into consideration the surroundings in which furnished, the taxpayer's trade or business, or activity of the persons to whom the food and beverages are furnished) which are of a type generally considered to be conducive to business discussion.

68. Treas. Reg. § 1.274-5(b)(3)(iv) (1963).

69. Treas. Reg. § 1.274-5(b)(4)(iii) (1963).

70. Treas. Reg. § 1.274-5(b)(5)(iv) (1963).

71. Treas. Reg. § 1.274-5(b)(2) (1963).

72. When the taxpayer entertains a relatively large number of people, he will usually not be required to record each of their names. Rev. Proc. 63-4(15), 1963 INT. REV. BULL. No. 4, at 26.

73. In any situation where a class of readily identifiable individuals is involved, a designation of such class would be sufficient. For example, if a taxpayer entertains all of the stockholders of a small corporation, a designation such as "all of the stockholders of Acme Corporation" would be sufficient. Rev. Proc. 63-4(15), 1963 INT. REV. BULL. No. 4, at 26.

74. [However,] . . . if the identity of a class, such as "customers of X Corporation," is not sufficient to identify the persons entertained, then an individual designation of each person entertained would be required. Even in this latter case, however, persons entertained may be readily identifiable from a more general designation such as "Mr. Jones, branch manager of Y Co. and his 15 salesmen." Rev. Proc. 63-4(15), 1963 INT. REV. BULL. No. 4, at 26.

75. Treas. Reg. § 1.274-5(b)(3)(v) (1963).

76. Treas. Reg. § 1.274-5(b)(4)(iv) (1963).

THE ELEMENTS

Type of Expenditure	Amount	Time	Place	Business Purpose	Business Relationship
A. Travel	Taxpayer must be able to prove the amount of each separate expenditure for traveling while away from home, such as the cost of his transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner, and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares. ⁵²	The dates of departure and return for each trip away from home, and the number of days away from home spent on business. ⁵⁶ In addition, because the new law requires allocation of travel expenses where the trip is partly personal, ⁵⁷ it becomes important to indicate the daily activities in the course of the trip. Since no allocation is required, where the non-business portion of the time away from home is less than 25 percent, the time factor also becomes important. ⁵⁸	The destination or locality of travel, described by the name of the city or town, or other similar description, must be shown. ⁶²	The business reason for the travel, or nature of the business benefit derived or expected to be derived as a result of the travel. ⁶⁶	This element is not applicable to travel expenses. ⁷¹
B. Entertainment in General	The taxpayer must show the amount of each separate expenditure, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis. ⁵³	The date of the entertainment must be shown. ⁵⁹	The name, if any, address and location, and designation of type of entertainment, such as dinner or theatre, if such information is not apparent from the designation of the place. ⁶³	The business reason for the entertainment or the nature of the business benefit derived or expected to be derived as a result of the entertainment. In addition, except for business meals, ⁶⁷ the nature of any business discussion or activity must be shown. ⁶⁸	The occupation or other information relating to the person or persons entertained, including the name, ⁷² title, ⁷³ or other designation, ⁷⁴ sufficient to establish the business relationship to the taxpayer. ⁷⁵

THE ELEMENTS (continued)

Type of Expenditure	Amount	Time	Place	Business Purpose	Business Relationship
C. Entertainment Preceding or Following a Bona Fide Business Discussion	Same requirements as for Entertainment in General. ⁵⁴	Both the date and the duration of the business discussion must be established. ⁶⁰	Same requirements as for Entertainment in General. ⁶⁴	The nature of the business discussion, and the business reason for the entertainment, or the nature of the business benefit derived or expected to be derived as a result of the entertainment. ⁶⁹	Identification of those persons entertained in who participated in the business discussion is required. ⁷⁶
D. Business Gifts	The cost of the gift to the taxpayer must be shown. ⁵⁵	The date of the gift must be shown. ⁶¹	A description of the gift must be furnished. ⁶⁵	The business reason for the gift or the nature of the business benefit derived or expected to be derived as a result of the gift. ⁷⁰	The occupation or other information relating to the recipient of the gift, including name, ⁷⁷ title, or other designation, ⁷⁸ sufficient to establish the business relationship to the taxpayer. ⁷⁹

77. It may not always be necessary, however, to record the name of the recipient. In some situations, a more general designation will be sufficient if it is evident that the taxpayer is not attempting to avoid the new \$25 annual limitation on the amount which can be deducted for gifts to any single individual. Rev. Proc. 63-4(16), 1963 INT. REV. BULL. No. 4, at 27.

For this limitation, see § 274(b).

78. For example, if a taxpayer purchases a large number of inexpensive tickets to local high school basketball games, and he distributes one or two tickets to each of a large number of his customers, it would usually satisfy the element of "business relationship" to record a general description of the recipients of the tickets. Rev. Proc. 63-4(16), 1963 INT. REV. BULL. No. 4, at 27.

To illustrate the type of records that taxpayers are required to maintain, Rev. Proc. 63-4, 1963 INT. REV. BULL. No. 4, at 32, provides some examples.

Example (1)

B, a vice-president of *Z* Corporation (the taxpayer), resides in Chicago, Illinois, where the home office of *Z* Corporation is located. *B* travels by airplane from Chicago to Dallas, Texas where he inspects a plant of the *Z* Corporation. He remains in Dallas for two days and returns to Chicago. During his stay in Dallas, he entertains Charles Young, the purchasing agent of the Sharpe Company, a prospective customer of the *Z* Corporation. *B* prepares, at or near the time of his expenditures, a statement of expense or similar record covering the elements of his expenditures . . . :

Travel Expenses

Date 1963	Item	Place	Amount	Business Purpose
April 1	Airplane fare (round trip— Chicago-Dallas).	Dallas	\$111.20	Inspect- tion of tion of Dallas plant.
	Lunch and tip		4.20	
	Lodging		18.50	
April 2	Meals and tip		6.50	
	Automobile rental (2 days)		22.00	
	Tips		1.50	

Entertainment Expenses

Date 1963	Item	Place	Amount	Business Purpose	Business Relationship
April 1	Dinner and tip.	Ajax Grill, Dallas.	\$16.50	Discuss purchase contract.	Charles Young, Purchasing Agent of Sharpe Co.

B should obtain receipts for his expenditures for lodging and air travel. If *Z* Corporation requires *B* to submit his statement of expense or similar record together with the receipts . . . then *Z* Corporation may be considered as substantiating the expenditures for which it reimburses *B*. In such a case, *B* ordinarily will not again be required to substantiate such expense account information.

* * *

Example (3)

D, the president of *Y* Corporation (the taxpayer), engages in a substantial and bona fide business discussion with three officers of Acme Corporation. Directly thereafter they go to the Flair Nightclub where *D* pays [\$14] for drinks at the bar . . . including [the] tip. They then go to the dining room where *D* pays the dinner bill of \$24, plus tip. *D* prepares, at or near the time of his expenditures a statement of expense or similar record of his expenditures . . . :

Entertainment Expenses

1-3-63: Taxi and tip (\$2.55); Drinks at bar and tip (\$14.00), dinner (\$24) and tip (\$4) at Flair Club, Washington, D.C.; entertainment of

B. *Show Me*

The elements described above indicate *what* must be substantiated. The next problem is *how* to substantiate these items.

1. RULES FOR SUBSTANTIATION—IN GENERAL

To obtain a deduction for an expenditure for travel, entertainment or gifts, each element must be substantiated by adequate records or by sufficient evidence corroborating the taxpayer's own statement.⁸⁰ These records must be made at or near the time of the expenditure, and must be supported by sufficient documentary evidence.⁸¹

2. ADEQUATE RECORDS

a. Diary

(1). In General.—To meet the adequate records requirements of section 274(d), the taxpayer must maintain an account book, diary, statement of expense or other similar records,⁸² which must be maintained in such a manner that each recording of an element of an expenditure is made at or near the time of the expenditure.⁸³ In other words, the recording must be made at a time when the taxpayer has full present knowledge of each element of the expenditure.⁸⁴ It is not necessary to record information in an account book, etc., which duplicates information reflected on a receipt so long as these records complement each other in an orderly manner.⁸⁵

(2). Transcriptions.—An expense account statement which is a transcription of an account book, diary, or similar record prepared in

president Black, vice president Chum, and treasurer Drew of the Acme Corporation, following business meetings . . . at my office all afternoon concerning proposed distributorship arrangement between Y and Acme Corporations.

D need not obtain a receipt for either the dinner bill or the bar bill, since both are less than \$25. If Y Corporation requires *D* to submit his statement of expense or similar record together with the receipt, and it verifies and maintains such record and receipt, then Y Corporation may be considered as substantiating the expenditures for which it reimburses *D*. In such a case, *D* ordinarily will not again be required to substantiate such expense account information.

79. Treas. Reg. § 1.274-5(b)(5)(v) (1963).

80. The supporting evidence should be made available to examining agents when tax returns are audited. It is not required or expected that taxpayers submit supporting records or documents as attachments with their tax returns as filed. Announcement 63-37, 1963 INT. REV. BULL. No. 13, at 25.

81. Treas. Reg. § 1.274-5(c)(1) (1963).

82. No special form of record or diary is prescribed, but the entries must be made on the records while the taxpayer has full present knowledge of his expenditures. Rev. Proc. 63-4(6), 1963 INT. REV. BULL. No. 4, at 25.

83. Treas. Reg. § 1.274-5(c)(2)(ii) (1963).

84. Treas. Reg. § 1.274-5(c)(2)(ii)(a) (1963).

85. *Ibid.* Even under the old law, diaries were helpful in establishing the fact of expenditure. Clark Fashions, Inc., 30 P-H Tax Ct. Mem. 648 (1961); Walter E. Ditmars, 30 P-H Tax Ct. Mem. 547 (1961); Joseph L. Weinfield, 30 P-H Tax Ct. Mem. 75 (1961).

accordance with the requirements of section 274(d) will be considered an adequate record if the expense account statement is submitted by an employee to his employer, or by an independent contractor to his client or customer in the regular course of good business practice.⁸⁶

b. Substantiation of Good Business Purpose

Generally, a written statement is required to substantiate the elements of business purpose. However, when the business purpose of an expenditure is evident from the surrounding facts and circumstances, a written explanation is not required. The regulations cite as an example, the case of a salesman calling on customers on an established sales route. In this situation, no written explanation of the business purpose of the travel will be required. Also, in the case of a business meal described in section 274(e)(1), no written explanation of business purpose is required if the business purpose of the meal is evident from the business relationship to the taxpayer of the person entertained, and other surrounding circumstances.⁸⁷

c. Confidential Information

There may be compelling reasons for not listing the subject matter of a business conference, or even the names or titles of the persons entertained. For instance, when there are secret conferences regarding a proposed merger of two corporations, the parties may not want the information divulged to secretaries, clerks, or others who would normally handle the processing of expense accounts. In this situation, recording of the information in the diary or expense allowance statement is not required. However, the information omitted must be recorded elsewhere at or near the time of the expenditure and must be available to the Internal Revenue Service for substantiation.⁸⁸

3. DOCUMENTARY EVIDENCE

a. In General

Documentary evidence will ordinarily consist of receipts, paid bills, cancelled checks, or similar evidence. This evidence is required for:

1. Any expenditure for lodging while away from home⁸⁹
2. Any other expenditure of twenty-five dollars⁹⁰ or more⁹¹

86. Treas. Reg. § 1.274-5(c)(2)(i) (1963). The Commissioner of Internal Revenue, Mortimer M. Caplin, explained that it is unnecessary for a salesman to "whip out a notebook and write down the item as he and his client finish their steak. The expenditure can be noted the next morning or even a few days later. [On the other hand,] it will not be regarded as 'contemporaneous' if it is recorded from memory several months later." *Wall Street Journal*, Dec. 28, 1962, p. 3, col. 2.

87. Treas. Reg. § 1.274-5(c)(2)(ii)(b) (1963).

88. Treas. Reg. § 1.274-5(c)(2)(ii)(c) (1963).

89. Treas. Reg. § 1.274-5(c)(2)(iii)(a) (1963).

90. The proposed regulations under § 274(d) required documentary evidence for any expenditures of \$10 or more. 17 J. TAXATION 365 (1962). The final regulations require such evidence only for expenditures of \$25 or more.

91. Treas. Reg. § 1.274-5(c)(2)(iii)(b) (1963).

However, no documentary evidence will be required for transportation charges if the evidence is not readily available.⁹²

b. Sufficiency

(1). Generally.—Ordinarily, documentary evidence is adequate if it includes sufficient information to establish the amount, date, place and the essential character of the expenditure.⁹³

(2). Hotel Receipt.—A hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, or telephone.⁹⁴

(3). Restaurant Receipt.—A restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, date and amount of the expenditure, and a notation of charges, if any, for other than food and beverages.⁹⁵

(4). Check.—A cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. However, a cancelled check drawn to the order of a named payee would not *of itself* support a business expenditure without other evidence showing that the check was used for a certain business purpose.⁹⁶

(5). Conventions.—Many firms, businesses and professional organizations hold conventions each year. A few are held outside the United States. Because, under the new law,⁹⁷ the taxpayer must establish the portion of the time away from home outside the United States which was devoted to business, it becomes important to document the "time" element as carefully as any of the other required elements. Failure to prove that at least seventy-five per cent of the time spent was on business will necessitate proration of the expenses.⁹⁸ Failure to prove that the primary purpose of the trip was business will preclude deduction of any expenses.⁹⁹

Suggested methods of establishing the "time" and "business purpose" elements are:

- a) Keep a copy of the convention program, indicating the business sessions given.
- b) At the sessions, take notes which should be retained.

92. *Ibid.*

93. Treas. Reg. § 1.274-5(c)(2)(iii)(b) (1963).

94. *Ibid.*

95. *Ibid.*

96. Treas. Reg. § 1.274-5(c)(2)(iii)(b) (1963).

97. Section 274(c), as amended by the Revenue Act of 1964, retroactive to January 1, 1963. Prior to the enactment of the amendment, the section applied to domestic travel also.

98. *Ibid.*

99. *Ibid.*

- c) If the session has a sign-in book, sign in.
- d) Keep a diary.
- e) Pay by business check and get receipted bills.¹⁰⁰

c. Retention of Records

The voluminous amount of information that will have to be accumulated and retained by the employer raises the problem of how long the employer must keep the records and documents. The Commissioner has not prescribed any special time (as he has discretion to do under the regulations),¹⁰¹ but has stated that the general statutes of limitation govern.¹⁰² A recent government publication states that the records should be retained "so long as the contents thereof may become material in the administration of any internal revenue law."¹⁰³

Another problem is who keeps the records? Must the employee keep duplicate copies of records or documentary evidence which he turns over to his employer? Since the employer will always have to substantiate by documentary evidence any expense accounts or reimbursements given to employees, it is always necessary for the employer to keep the receipts or documentary evidence. The employee will have to keep duplicate copies *only* in the following instances:¹⁰⁴

1. When he seeks to deduct *any* travel, gift, or entertainment expenditures on his own tax return¹⁰⁵
2. When he does not make an adequate accounting to his employer¹⁰⁶
3. When he is related to his employer¹⁰⁷

When duplicate records are required, and the cost of photostating would be prohibitive, the employee might still meet the test of "substantial compliance" by borrowing the required records from the employer for the purpose of the tax examination.

4. OTHER SUBSTANTIATION

a. Substantial Compliance

(1). In General.—If the taxpayer has not fully substantiated a particular element of an expenditure but has "substantially complied" with the adequate records requirements, he may establish the element by other sufficient evidence.¹⁰⁸

100. P-H TRAVEL AND ENTERTAINMENT EXPENSE DEDUCTION HANDBOOK 18 (1963).

101. Treas. Reg. § 1.274-5(c)(2)(iv) (1963).

102. Rev. Proc. 63-4(30), 1963 INT. REV. BULL. No. 4, at 29.

103. Guide to Record Retention Requirements X 4.2 & 4.7, 29 Fed. Reg. 3055-56 (1964).

104. Rev. Proc. 63-4(32), 1963 INT. REV. BULL. No. 4, at 30.

105. See II(B)(8) of this article's text *infra*.

106. *Ibid*.

107. *Ibid*.

108. Treas. Reg. § 1.274-5(c)(2)(v) (1963).

(2). Other Sufficient Evidence.—When the taxpayer has complied substantially, rather than fully, with the adequate records requirements, he must, in addition, substantiate the required element:

- a) By his own statement in writing containing specific information in detail as to the element,¹⁰⁹ and
- b) By other corroborative evidence sufficient to establish the element.¹¹⁰

(3). Corroboration.—In order to constitute “other adequate evidence,” a particular type of evidence is required. In the case of a gift, or the cost, time, place or date of an expenditure, the corroborative evidence has to be direct evidence, such as documentary evidence or a statement in writing or the oral testimony of the person entertained, or other witness, setting forth detailed information about the element.¹¹¹ In the case where the element is either the business relationship to the taxpayer or persons entertained, or the business purpose of an expenditure, the corroborative evidence may be circumstantial.¹¹²

b. Substantiation in Exceptional Circumstances

(1). Inherent Nature of Situation.—By reason of the inherent nature of the situation in which an expenditure was made, the taxpayer may be unable to conform to either the “adequate records” requirements¹¹³ or the “other sufficient evidence” requirements¹¹⁴ listed above. In this situation, the taxpayer may present other evidence which possesses the “highest degree of probative value possible under the circumstances.”¹¹⁵

(2). Loss of Records.—When due to circumstances beyond the control of the taxpayer, such as destruction by fire, flood, earthquake or other casualty, the taxpayer is unable to produce adequate records, he will be permitted to substantiate a deduction by a reasonable reconstruction of his expenditures.¹¹⁶

5. SPECIAL PROVISIONS

a. Separate Expenditure

(1). In General.—Ordinarily, each separate payment constitutes a separate expenditure. However, concurrent or repetitious expenses of a similar nature occurring during the course of a single event are considered to constitute a separate expenditure.¹¹⁷

109. Treas. Reg. § 1.274-5(c)(3)(i) (1963).

110. Treas. Reg. § 1.274-5(c)(3)(ii) (1963).

111. *Ibid.*

112. *Ibid.*

113. Treas. Reg. § 1.274-5(c)(2) (1963).

114. Treas. Reg. § 1.274-5(c)(3) (1963).

115. Treas. Reg. § 1.274-5(c)(4)(iii) (1963).

116. Treas. Reg. § 1.274-5(c)(5) (1963).

117. Treas. Reg. § 1.274-5(c)(6)(i)(a) (1963).

For example, when a taxpayer entertains a business guest at dinner and thereafter, at the theatre, the payment for dinner constitutes one expenditure, and the payment for the theatre tickets constitutes a separate expenditure.¹¹⁸ If, during a day of business travel, the taxpayer makes separate payments for breakfast, lunch, and dinner, he has made three separate expenditures. However, if during entertainment at a cocktail lounge the taxpayer pays separately for each round of drinks, the total amount of drinks will be treated as a single expenditure. A tip may be treated as a separate expenditure.¹¹⁹

(2). Aggregation.—In the diary or expense statement required under the “adequate records” provisions, recording must be made with respect to each separate expenditure, and not with respect to aggregate amounts for two or more expenditures. For example, each expenditure for “lodging” or “air travel” items should be recorded separately. On the other hand, the taxpayer may aggregate amounts expended for breakfast, lunch, and dinner, as “meals.”¹²⁰ A tip or gratuity which is related to an underlying expense may be aggregated with the expense.¹²¹ However, the taxpayer may separately state the daily aggregate of tips.¹²² As a practical matter, it may prove more advantageous for the taxpayer to state the tip separately. Consider, for example, the following situation: Smith takes a group of customers out to dinner, and the check amounts to twenty-three dollars. He leaves a tip of four dollars. If Smith chooses to aggregate the tip with the check, his expenditure will be in excess of twenty-five dollars, and he will be required to have a receipt or paid bill.¹²³ If, however, Smith elects to treat the tip separately, no receipt for the meal or the tip will be required.¹²⁴

b. Allocation

If a taxpayer has established the amount of an expenditure, but is unable to establish the portion attributable to each person participating in the event, allocation can be made to each person on a pro-rata basis. Therefore, the total number of persons participating must be established in order to compute the portion allowable to each person.¹²⁵

When a taxpayer purchases season tickets to events, such as to home games of a baseball team, and either sends them as business gifts to customers, or uses them in entertaining customers, he must treat each ticket in the series as a separate item, and allocate the cost of

118. *Ibid.*

119. *Ibid.*

120. Treas. Reg. § 1.274-5(c)(6)(i)(b) (1963).

121. *Ibid.*

122. Rev. Proc. 63-4(19), 1963 INT. REV. BULL. No. 4, at 27.

123. Treas. Reg. § 1.274-5(c)(2)(iii)(b) (1963).

124. *Ibid.*

125. Treas. Reg. § 1.274-5(c)(6)(ii) (1963).

the season ticket accordingly. He must also keep records as to the use of each ticket for a gift, or as entertainment, as the case may be.¹²⁶

c. Entertainment Facilities

Under section 274(a)(1)(B), the taxpayer is required to establish that the entertainment facility was used primarily for the furtherance of his trade or business.¹²⁷ In order to establish this fact, the taxpayer has to maintain records of:

1. The use of the facility
2. The cost of using the facility (in the case of yachts, this might include general operating costs, such as maintenance, repairs, insurance, dockage fees, license fees, and depreciation)¹²⁸
3. Mileage, in the case of yachts and the like
4. Other information which would establish the primary use.¹²⁹

These records must contain:

1. The elements of an expenditure, as required generally for all travel and entertainment expenditures under section 274(d)¹³⁰
2. A description of the *non-business use* of the facility, including cost, date, number of persons entertained, and, if applicable, information such as mileage or its equivalent, (a notation such as "personal use," or "family use," with the date of the use, would be sufficient to describe the nature of the entertainment).¹³¹

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it will be presumed that the use of the facility was primarily personal.¹³² To illustrate, consider the following situation: X Corporation, engaged in the manufacture of auto parts, maintains a yacht for the purpose of

126. Rev. Proc. 63-4(17), 1963 INT. REV. BULL. No. 4, at 27.

127. The taxpayer must also establish that the item was directly related to the active conduct of the trade or business.

One observer, in a tongue-in-cheek article, suggests that facilities be labeled as such to establish the fact of business use. He realizes, however, that under certain circumstances the labeling might be misconstrued:

If a businessman rented a certain hotel bedroom throughout the year for use of out-of-town buyers, I am not sure how people would react to a sign on the door reading "JOHN SMITH-BUSINESS FACILITY No. 5." Blum, *How to Succeed in a Business Deduction Without Really Trying*, 40 TAXES 1074, 1078 (1962).

The term "facility" includes any item of personal or real property owned by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, hotel suite, dining room or cafeteria. Sen. Fin. Rep., p. 17.

128. Rev. Proc. 63-4, example 5, INT. REV. BULL. No. 4, at 34.

129. Treas. Reg. § 1.274-5(c)(6)(iii) (1963).

130. Treas. Reg. § 1.274-5(c)(6)(iii)(a) (1963).

131. Treas. Reg. § 1.274-5(c)(6)(iii)(b) (1963).

132. *Ibid.*

entertaining company customers and employees. To be considered adequate, a record of use might show the following information:¹³³

Week Beginning July 7, 1963

July 10, 1963

Negotiate and sign contract to manufacture engine blocks for Williams Motor Co.; sailing on Salt Bay 9 A.M. [to] 6 P.M.; contract negotiations 6 hours. [The following persons were present:]

Mike Roberts—president of X
 Don Jones—vice-president of X
 Frank Brown—manager of X
 Stan Williams—president of Williams Motor Co.
 Bob Fleming—general manager of Williams Motor Co.
 Ernie Edwards—office clerk of X Corp.

July 12, 1963

Personal use by company officers—9 A.M. to 4 P.M.

July 13, 1963

Employee recreation; 10 A.M. [to] 8 P.M. Fishing and sun bathing—Salt Bay. [The following persons were present:]

Frank Brown—manager of X Corp.
 Ben Smith—assistant manager of X Corp.
 Ernie Edwards—office clerk of X Corp.
 Mary Sanders—secretary of X Corp.
 Jim Phillips—stock room employee of X Corp.

d. Additional Information

When it is necessary to clarify information contained in records, statements, testimony, or documentary evidence, or to establish the reliability or accuracy of the records, etc., the District Director may obtain any additional information he deems necessary, by personal interview or otherwise.¹³⁴

6. SPECIFIC EXCEPTIONS

Substantiation under the strict requirements listed above is not required in the case of expenditures described in:

(1) Section 274(e)(2), relating to food and beverages furnished on the employer's business premises primarily for employees.¹³⁵ This would ordinarily include cafeterias and executive dining rooms. The occasional serving of others would not nullify the exception.

(2) Section 274(e)(3), relating to expenses treated as compensa-

133. Rev. Proc. 63-4, example 5, 1963 INT. REV. BULL. No. 4, at 34.

134. Treas. Reg. § 1.274-5(c)(6)(iv) (1963).

135. Treas. Reg. § 1.274-5(c)(7)(i) (1963).

tion.¹³⁶ However, the employer must treat the payment as he would compensation on his tax return, and must withhold income taxes.

(3) Section 274(e)(8), relating to goods, services and facilities made available to the general public.¹³⁷ This would include expenses for entertainment of the general public by means of radio, newspapers, etc.¹³⁸

(4) Section 274(e)(9), relating to entertainment sold to customers.¹³⁹ This would include the cost of producing entertainment for sale to customers, or the cost of operating a pleasure cruise ship as a business.¹⁴⁰

Also excepted from the requirements of section 274(d) are expenditures for activities listed in section 274(e)(5), relating to recreational, etc., expenses for employees.¹⁴¹ However, the taxpayer must still be able to establish that the expenses were not incurred primarily for employees who are officers, shareholders, or other owners, who own directly or indirectly ten percent or more of the taxpayer's trade or business.¹⁴² In addition, section 274 in its entirety, is inapplicable to items which would be deductible by the taxpayer whether or not he was engaged in a trade or business. This would include such items as taxes, interest and casualty losses.¹⁴³

7. DISCLOSURE

The Commissioner may, in his discretion, prescribe rules under which any taxpayer claiming a deduction for entertainment, gifts, or travel, or any other person receiving advances, reimbursements or allowances for these items, is required to make disclosure on his tax return with respect to the deductions.¹⁴⁴

For 1963, businesses generally were not faced with new disclosure requirements on their tax returns for expense account allowances.¹⁴⁵ With regard to the statement which must be attached to the taxpayer's return when there is no adequate accounting,¹⁴⁶ or when certain other conditions exist,¹⁴⁷ a consideration of employee expense accounts is appropriate.¹⁴⁸

136. *Ibid.*

137. *Ibid.*

138. Sen. Fin. Rep., p. 177.

139. Treas. Reg. § 1.274-5(c)(7)(i) (1963).

140. Sen. Fin. Rep., p. 177.

141. Treas. Reg. § 1.274-5(c)(7)(ii) (1963).

142. For definition of "directly or indirectly," see § 267(b). For purposes of § 267(b)(2), the percentage used should be 10%.

143. Section 274(f).

144. Treas. Reg. § 1.274-5(d) (1963).

145. Rev. Proc. 63-4(34), 1963 INT. REV. BULL. No. 4, at 30.

146. See note 149 *infra*.

147. See note 154 *infra*.

148. The service is presently making a full study of the disclosure area, probably with

8. EMPLOYEE EXPENSE ACCOUNTS

The rules enumerated thus far relate primarily to the requirements necessary for a taxpayer who is in a trade or business to obtain a deduction for travel, entertainment, or gift expenditures. These rules, then, apply to the employer who is seeking to obtain a deduction for the expenditures, rather than to the particular employee, who is actually spending the money. The corporation will usually incur this type of expense only indirectly, through reimbursing the employee or giving him an expense allowance. It is the reimbursement or the allowance that the corporation is seeking to deduct; it is with regard to these payments that compliance with the substantiation requirements of section 274(d) is necessary. In other words, the employer has to be able to substantiate each element of the expenditure, even though the actual expenditure was made by the employee out of his own funds. This places the burden on the employer to obtain the required information from his employees in order to obtain a deduction for the allowances or reimbursements. When the corporation disburses the funds directly, it will usually be a simple matter to obtain the required information, *i.e.*, paid bills, cancelled checks.

So much for the employer. What burden is placed on the employee by the new rules? The answer depends on whether or not the employee is required to make an adequate accounting¹⁴⁹ to his employer.

a. Reporting of Expenses for which the Employee Is Required
To Make an Adequate Accounting to His Employer

When the employee is reimbursed for the actual amount of his expenses, and in addition, makes an adequate accounting to his employer, he is ordinarily excused¹⁵⁰ from reporting either the reimburse-

a view toward stiffening present requirements. Rev. Proc. 63-4(34), 1963 INT. REV. BULL. No. 4, at 30.

149. [A]dequate accounting means the submission to the employer of an account book, diary, statement of expense, or similar record maintained by the employee in which the information as to each element of an expenditure . . . is recorded at or near the time of the expenditure, together with supporting documentary evidence, in a manner which conforms to all of the "adequate records" requirements. . . .

An adequate accounting requires that the employee account for all amounts received from his employer during the taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the employer through credit cards or otherwise) for travel, entertainment, and gifts.

For purposes of adequate accounting the employee may *not* substantiate by "other sufficient evidence" (*i.e.*, establishing an element by the employee's own statement and other corroborative evidence). Treas. Reg. § 1.274-5(e)(4) (1963).

150. There are two situations where an "adequate accounting" by the employee is insufficient to bar further disclosure on the employee's tax return. The first is where the employee is related to his employer. An employee is considered related if he has directly or constructively (see § 267(b)) a 10% or more interest in his employer. The second situation is where the Internal Revenue Service does not consider the accounting procedures used by the employer for the reporting and substantiation of expenses by his employees, adequate. Such condition would arise, for example, where the expense account is not verified and

ment received or the expenses incurred, on his own tax return. However, the expenses must have been paid or incurred by him *solely* for the benefit of his employer.¹⁵¹ When the reimbursement received by the employee is in excess of his actual expenses in behalf of his employer, the employee is required to report only the excess on his tax return as additional income.¹⁵² These provisions should simplify the preparation of the tax return of an employee who accounts fully to his employer, and who is not claiming any deduction on his own tax return for business expenses relating to travel, entertainment, or gifts. When, however, the employee wishes to claim a deduction on his personal tax return for expenses which were not fully reimbursed by his employer, he must submit a statement with his tax return,¹⁵³ and be able to substantiate all his expenses,¹⁵⁴ as though he had *not* made an adequate accounting to his employer. In other words, he may be required to substantiate all of his expenses *twice*—once when he makes an adequate reporting to his employer, and again, when he prepares his own tax return. This requirement should encourage employees to obtain full reimbursement from their employer. Failure to do so may expose the employee to the following hypothetical situation:

Jones, employed by X Corporation as a public relations officer, is required to do extensive traveling and entertaining in connection with his corporate duties. He spends his own funds, and is later reimbursed by the company, after he makes an adequate accounting to them. In the course of a year, he may legitimately incur expenses in excess of 3,000 dollars, for which he receives full reimbursement. In December, however, there is an economy drive in the firm, and the word is out that expense accounts are to be reduced. Jones spends 300 dollars in December, but is limited to a reimbursement of 250 dollars by his firm. Jones is fully able to substantiate 300 dollars under the requirements of section 274 (d).

If Jones seeks to deduct the fifty dollars on his tax return as "un-reimbursed travel and entertainment expenses incurred in connection with employment" (or words of similar import), he must include with his tax return, a statement¹⁵⁵ showing his total reimbursements (3,000 dollars), and other information generally required only of those who do *not* account to their employer. In addition, he has to be able to substantiate,¹⁵⁶ and thus expose to government scrutiny, all of his ex-

approved by a person *other* than the person incurring the expenses. Treas. Reg. § 1.274-5 (e) (5) (1963).

151. Treas. Reg. § 1.274-5(e)(2)(i) (1963).

152. Treas. Reg. § 1.274-5(e)(2)(ii) (1963).

153. Treas. Reg. § 1.274-5(e)(2)(iii)(a) (1963).

154. Treas. Reg. § 1.274-5(e)(2)(iii)(b) (1963).

155. For the information which must be included in the statement, see II(B)(8)(b) of this article's text *infra*.

156. A corporate officer who claims a deduction for travel and entertainment expenses

penses for the year (3,050 dollars). It would take a brave man to assume the risk.¹⁵⁷

If an employer purchases directly any ticket or other travel item for an employee's use, the employee need not record the amount of the item. However, if the employee pays for the trip by the use of a credit card or otherwise and charges the item to his employer, he must then make a record of the expenditure.¹⁵⁸

b. Reporting of Expenses for which the Employee *Is Not* Required To Make an Adequate Accounting to His Employer

If the employee is not required to make an accounting¹⁵⁹ to his employer for his business expenses, or though required, fails to make an adequate accounting for the expenses, he must submit as a part of his tax return, the following information:¹⁶⁰

1. The total amounts received as advances from his employer, including amounts charged directly or indirectly to the employer through credit cards¹⁶¹
2. The nature of his occupation¹⁶²
3. The number of days away from home on business¹⁶³
4. The total amount of business expenses paid or incurred by him broken down into such categories as transportation, meals and lodging while away from home overnight,¹⁶⁴ entertainment, gifts, and other business expenses¹⁶⁵

In addition, the employee must maintain records and supporting evidence that will substantiate each element of an expenditure.¹⁶⁶

c. Per Diem, Mileage and Other Traveling Allowances

It was previously stated that one of the elements that must be substantiated by adequate records is the "amount" of the expenditure.

incurred on behalf of a corporation must bear the burden of proof that he is entitled to the deduction. Rev. Rul. 502, 1957-2 CUM. BULL. 118.

157. In addition to exposing all of his reimbursed expenses to government scrutiny, the chances of his return being selected for examination would be greatly increased. It is no secret that "unusual" deductions (especially in sizeable amounts) appearing on a return would be likely to cause an agent, or an electronic processing machine, to select the return for examination.

158. Rev. Proc. 63-4(18), 1963 INT. REV. BULL. No. 4, at 27.

159. See note 149 *supra*.

160. Form 2106 may be used to supply the required information.

161. Treas. Reg. § 1.274-5(e)(3)(i) (1963).

162. Treas. Reg. § 1.274-5(e)(3)(ii) (1963).

163. *Ibid*.

164. The Revenue Service has contended that meals and lodging are only deductible for travel away from home overnight. However, a 1962 decision, *Hanson v. Commissioner*, 298 F.2d 391 (8th Cir. 1962) held that the overnight requirement was an arbitrary line-drawing, having no basis in the tax law. The court saw no valid distinction between a two-day business trip and a one-day business trip.

165. Treas. Reg. § 1.274-5(e)(3)(ii) (1963).

166. Amount; Time; Place; Business Purpose; and Business Relationship.

In addition, the requisites of an adequate accounting to the employer were delineated.¹⁶⁷ Compliance with these requirements is obviated where, in accordance with reasonable business practice, the employer establishes either:

1. Per diem allowances or reimbursement arrangements covering ordinary and necessary expenses of traveling away from home (exclusive of transportation costs or expenses to and from destination), provided, however, that the amounts do not exceed twenty-five dollars per day,¹⁶⁸ or

2. Mileage allowances providing for ordinary and necessary expenses of transportation while away from home, provided, however, that the amounts do not exceed fifteen cents per mile¹⁶⁹.

When the presence of unusual circumstances justifies an allowance in excess of twenty-five dollars per day or fifteen cents per mile, the employer should request a ruling from the Commissioner as to the deductibility of the excessive allowance.¹⁷⁰ In the case of reimbursements for travel away from home and per diem allowances, the employer must reasonably limit payment of the expenses to those which are ordinary and necessary in the conduct of his trade or business.¹⁷¹ In addition, the elements of time, place and business purpose of the travel still must be substantiated.¹⁷² In the case of a fixed mileage allowance for transportation while away from home, once again, the elements of time, place, and business purpose must be established.¹⁷³ If an employee receives an amount in excess of his deductible business expenses, he must include the excess amount in his gross income.¹⁷⁴

As stated above, the employee need not establish the dollar amounts of any expenditures for which he receives a reimbursement within the prescribed limits. The question then arises as to how the examining Internal Revenue agent will determine whether there were any payments in excess of the employee's deductible business expenses. This would necessarily involve keeping total dollar amounts of daily expenditures,

167. *Supra* note 149.

168. Rev. Rul. 63-13, 1963 INT. REV. BULL. No. 4, at 21.

169. *Ibid.*

170. *Ibid.*

171. Whether the employer reasonably limits reimbursement of travel expenses depends on whether the employer maintains adequate internal controls, such as requiring an employee's expense account to be verified and approved by a responsible person other than the employee incurring the expense. Rev. Rul. 63-13, INT. REV. BULL. No. 4, at 21.

Whether the employer reasonably limits per diem allowances depends on whether the employer's travel allowance practices are based on reasonably accurate estimates of travel costs, including recognition of cost variances encountered in different localities. Rev. Rul. 63-13, 1963 INT. REV. BULL. No. 4, at 21.

172. *Ibid.*

173. *Ibid.*

174. *Ibid.*

the very thing that the reimbursement rules do not seem to require. Until this point is fully clarified by the service, employees under these arrangements may be wise to follow the more detailed record keeping and substantiation requirements to which other taxpayers are now subject.¹⁷⁵

d. Automobile Expenses of Self-Employed Persons or Non-Reimbursed Employees

According to the principles previously considered, an employee who receives fifteen cents a mile for travel expenses need not substantiate the amount of his expenditure, nor need he meet the requirements of an "adequate accounting" to his employer. These rules only apply to employees who receive reimbursements from their employers. Until recently, employees who claimed these expenses but received no reimbursement were required to maintain detailed records of their expenditures. A recent Revenue Procedure,¹⁷⁶ however, has extended similar simplified rules to persons in this category.

Under this Revenue Procedure (which is retroactive to January 1, 1963), a self-employed individual or employee may choose to compute the deductible costs of operating his auto for business purposes by use of a standard mileage rate of ten cents per mile for the first 15,000 miles of business use and seven cents per mile for any usage over 15,000 miles. Use of this method is optional on a yearly basis.¹⁷⁷

C. Independent Contractors

The preceding sections of this article dealt with the substantiation requirements for reimbursements and expense allowances involving an employer-employee relationship. It is quite common, however, for a taxpayer to reimburse or give an expense allowance to someone who is not the taxpayer's employee. For instance, a client may retain an attorney to enter into negotiations for the acquisition of a new plant, and the attorney may have to travel and do some entertaining in connection with the negotiations. If the attorney receives reimbursement from the client for the expenditures, must the client obtain receipts, paid bills, or other documentary evidence from the attorney? The regulations recognize that the client or customer does not possess the same degree of ability to compel the production of records or receipts from one who is not an employee, as he would from one who is. Therefore, generally, the attorney would be the only one required to maintain records and

175. 18 J. TAXATION 352 (1963).

176. Rev. Proc. 64-10, 1964 INT. REV. BULL. No. 6.

177. This method cannot be used where the employee claims a deduction in excess of reimbursements received from his employer. If the employee receives less than ten cents a mile, he is limited to the amount he actually received. For other limitations, see Rev. Proc. 64-10, 1964 INT. REV. BULL. No. 6.

documentation to substantiate a deduction. The client will *not* be required to obtain records and documentary evidence from his attorney concerning travel, gifts, or entertainment in order to deduct the reimbursed expenses. When, however, the attorney *does* account to his client for *entertainment* expenditures, the client must be prepared to substantiate, and accordingly must maintain the required documentation.

One may wonder why the attorney would want to account to his client by providing him with detailed records and documentary evidence of reimbursed entertainment expenses. It may be that the client is unwilling to make the reimbursement in the absence of proof. In addition, under the new substantive rules, certain good will entertainment may not be deductible.¹⁷⁸ However, if an independent contractor incurs an expense under a reimbursement arrangement with his client, the expense will not be disallowed to the attorney if he *does* adequately account to his client by providing adequate records, including required documentary evidence of the expense.¹⁷⁹ Even when the attorney does adequately account to his client for reimbursed entertainment expenses, the attorney is still required to maintain adequate records of the expenditure, including receipts or copies of receipts.¹⁸⁰ When the obtaining of copies of documents would be impractical, the attorney might still meet the test of substantial compliance by merely borrowing the required records from his client for the purpose of the tax examination.

III. THE RESULT

The Missouri rule (section 274(d)) has been in effect for almost two years at the time of this writing. The full impact of the rule has not yet been felt, however, and will not be fully realized until the rule is enforced by the Internal Revenue Service in the course of examining returns which have been filed for periods ending after December 31, 1962.

A. *The Businessman*

Section 274(d) will have a formidable impact on business practice, and on the conduct of tax controversies. The scope and caliber of the impact will vary, depending on the type and size of the business involved and the extent to which the business is tax-conscious.

The large corporation probably will be the least affected. This does not mean that it will not have to make drastic changes in its accounting procedures.¹⁸¹ New employees may have to be hired to handle

178. Section 274(a).

179. Section 274(e)(4)(B).

180. Rev. Proc. 63-4(29), 1963 INT. REV. BULL. No. 4, at 29.

181. In questioning the need for the masses of detailed information required under the

the extra paperwork. Storage facilities will have to be provided to accumulate the mountain of data which will have to be submitted to the company. New expense account forms may have to be designed. New programs will have to be prepared for electronic business machines and similar equipment. To prove that no gifts of more than twenty-five dollars in value were made to any individual during the year, a completely detailed subsidiary ledger may have to be maintained. The executive whose function it is to approve expense accounts may find that he has to devote a great deal more time to scrutinizing expense accounts to insure that the requirements of the law are being met.¹⁸² On the other hand, it has been suggested that the corporate tax man may even welcome the new rules, at least to the extent that they may enable him to obtain a more accurate and complete accounting from employees incurring travel and entertainment expenses.¹⁸³

The burden on the medium-sized business will be infinitely greater. As the size of the firm decreases, the more informal the accounting procedures of the firm are likely to be. Internal control is also reduced, since one employee may perform several functions. Formality as to expense account procedures also tends to be more lax, since usually only a few top officers (who may also be stockholders) receive expense accounts. The new rules, however, tolerate little informality. Meticulousness is the standard.¹⁸⁴ The medium-sized firm is less equipped to cope with the new rules, and psychologically, may be less tax-conscious than the large firm. It will also be more difficult to meet the tests of an "adequate accounting" since the degree of internal control present may not be sufficient, *i.e.*, persons approving expense accounts may be the same ones receiving the allowances.

It is upon the small businessman and the outside salesman that the burden of the new rules will fall most heavily. The small firm, with

new regulations, the Committee on Federal Taxation of the American Institute of Certified Public Accountants stated:

Business is constantly on the alert for cost saving techniques in the accumulation of information and record keeping. The detailed information required is a big step in the opposite direction. Modern business practice is to establish internal controls to accomplish most of the result sought. The . . . regulations seek to accomplish the result by the accumulation of a mass of detailed records of doubtful practical value and questionable need. 115 J. Accountancy 31-2 (1963).

182. The Committee on Federal Taxation of the American Institute of Certified Public Accountants stated that "the proposed regulation would impose an unreasonable and costly burden on business in time and effort of employees in recording all of the voluminous and minute information demanded and in checking, filing and retaining records for possible review by examining authorities." 115 J. Accountancy 31 (1963).

183. Mills, *Problems of Corporate Administration in Connection with Travel and Entertainment Expenses*. 15 THE TAX EXECUTIVE 194 (1963).

184. The new rules have been subject to heavy criticism in Congress. Senator Smathers (D. Fla.) has been quoted as declaring that the rules "impose detail on top of detail and then top it all off by requiring so much proof that in my opinion the taxpayer must prove his case beyond a reasonable doubt. That's for criminal law . . . not the tax law." Wall Street Journal, March 1, 1963, p. 3, col. 4.

perhaps a few officers and a handful of employees, including perhaps one bookkeeper, will be least equipped to adhere to the new requirements. It is here that internal control is practically non-existent. The bookkeeper has her hands full with answering the telephone, paying bills, posting the books, writing letters, and seeing that customers are properly billed and dunned. Now she probably also will have to maintain her boss's diary, and convince him of the necessity of obtaining receipts. This lack of internal control results in the person receiving the expense allowance not having to account to anyone, and it probably has been an area of great abuse. But no law can make meticulous a small businessman whose success may be due precisely to the fact that he has little patience for detail. Further, the small firm may not be very tax-conscious, although in this day and age, one might doubt that any businessman can be totally unsophisticated as to tax matters. He may very well feel that compliance with these new rules is not worth the price—he can not afford to spend his time keeping detailed records and receipts. The result probably will be that he will either try to reduce the amount of entertaining that he believes to be necessary in order to get business, or accept the fact that he will have to do his entertaining with non-deductible dollars. In defense of the new rules, one observer has suggested that if a businessman spends so much time in entertaining that writing up his diary seems unduly time-consuming, it seems appropriate to ask who is minding the store.¹⁸⁵

The burden will also be great on the traveling salesman who works strictly on a commission basis, and who must bear his own expenses of traveling, entertaining, and the giving of gifts. A man who calls on customers all day, and then wines and dines them in the evening, usually has little time to keep the required minutiae. He may well feel that if he were a good bookkeeper, he would not be a salesman. However, since his expenses constitute a large percentage of his gross income, he may very well be more strongly motivated to keep the required records, and may sublimate his reluctance to comply.¹⁸⁶

B. *The Government*

The Internal Revenue Service now has a strong weapon in its arsenal. Whether the exercise of its new power will be tempered with reason remains to be seen. Commissioner Caplin has tried to inculcate

185. Knickerbocker, *Entertainment and Related Deductions Under the Revenue Act of 1962*, 31 *FORDHAM L. REV.* 639 (1963).

186. A suggested solution to the burdens presented by the harshness of the new rules is to have a standard deduction for businessmen. In France, a 1% deduction is permitted to all firms for "general expenses" or *Frais Generaux*, and is a catch-all to cover entertainment and other legitimate expenses. Also, supplementary business deductions are permitted to individual taxpayers ranging from 30% for salesmen to 5% for watch and jewelry workers. Heckerling, *The Rise and Demise of the Cohan Rule*. LL.M. Thesis, University of Miami Law School. (1963).

his agents with the attitude that a spirit of fairness should prevail, and that the atmosphere of an inquisition should be avoided. Unreasonable and arbitrary application of the new rules to deny deductions *carte blanche* to a taxpayer who has made every reasonable effort to comply with their requirements would be unfortunate. This does not suggest that mere estimates should be allowed, but the "substantial compliance" provisions should be used to insure fairness. Tax examinations will now be simplified when records are scant. No more will there be haggling over what the taxpayer "probably" spent. Lack of substantiation will prove fatal to any claimed deduction for travel, entertainment, or gifts. On the other hand, one can well commiserate with the agent who is presented with a mountain of receipts, bills, petty cash slips, and assorted memoranda. One can speculate that the agent will not examine each and every voucher when a random sampling indicates a bona fide effort on the part of the taxpayer to comply with section 274(d).

C. *The Courts*

Litigation as to what would constitute a reasonable estimate under the *Cohan* rule should diminish as cases involving years prior to the effective date of the new rules¹⁸⁷ are disposed of. It must, however, be remembered, that the *Cohan* rule is still effective in the case of expenditures other than for travel away from home, entertainment, entertainment facilities, and gifts. Litigation will continue to involve these other items. When unreasonable application is made of the Missouri rule, courts may expand the scope of "substantial compliance" to avoid inequities. Mere estimates, however, appear doomed.

D. *The Tax Practitioner*

To the attorney or C.P.A., the new rules present several problems, the most pressing of which is the problem of education. Not only must he acquaint himself with the new law, but he must also be able to advise his client as to what is expected of him, and the penalty imposed for failure to comply. The law requires the businessman to become a bookkeeper. The difficulty will be in convincing the client of this fact and persuading him to adapt to the new rules. However, once the client gets in the habit of being meticulous about his record-keeping, the battle is won.

The next problem area is a ticklish one. Under *Cohan*, no ethical problems were presented by claiming a deduction for expenditures that were not documented. The law allowed reasonable approximations to be made. There was no problem as to whether or not to take the deduction. The question was, "How much?" This is not so under the new rules. No deduction is allowed for expenditures which are not properly

187. January 1, 1963.

substantiated in accordance with section 274(d). The tax practitioner may be under a moral and legal obligation to ask the client if the amounts claimed are properly substantiated, before claiming a deduction on the client's return. A negative answer would preclude the practitioner from claiming *any* deduction for those items.¹⁸⁸ Any other handling of the matter might place the practitioner in the position of having fraudulently claimed a deduction.¹⁸⁹ This is a far cry from the past procedure of asking the client: "Approximately how much did you spend on entertainment during the past year?"

As stated previously, tax examinations should be simplified.¹⁹⁰ The haggling over amounts of estimated expenditures allowable under the *Cohan* rule should cease. The objective standard of the Missouri rule should create more uniformity in tax examination results.

IV. CONCLUSION

The Missouri rule heralds a new way of life for all who must operate under its aegis: the taxpayer will be ever more deeply enmeshed in red tape; the government's enforcement machinery has been greatly enhanced;¹⁹¹ the courts will be guided by an objective legislative standard. Ah, yes, and the poor tax practitioner will find himself where he has always been—right in the middle.¹⁹²

188. Knickerbocker, *Entertainment and Related Deductions Under the Revenue Act of 1962*, 31 *FORDHAM L. REV.* 639, 659 (1963).

189. Crowley, *Bargaining Position or Fraud in Claiming Deductions*, N.Y.U. 19TH INST. ON FED. TAX. 1159 (1961); Cobert, *Criminal Consequences in Deducting Improper Expenses*, N.Y.U. 17TH INST. ON FED. TAX. 549 (1959).

190. It has been suggested that the best way for a practitioner to achieve top audit results for his client is to follow the regulations to the letter in setting up a client's records. The favorable impression created by the presentation to an agent of the data called for in the regulations, neatly arranged and summarized, will go a long way toward a successful conclusion of the audit. 18 *J. TAXATION* 32 (1963).

191. According to the Committee on Federal Taxation of the American Institute of Certified Public Accountants:

It is a practical impossibility for the most conscientious taxpayers to accomplish total compliance with [the] . . . regulations. They are too complex and the record-keeping requirements are too burdensome. 115 *J. ACCOUNTANCY* 32 (1963).

192. Mills, *Travel and Entertainment Expenses*, 22 *LOUISIANA CERTIFIED PUBLIC ACCOUNTANT* 14, 19 (1963).