OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: ASSOCIATE AREA COUNSEL,
CC:LM:MCT

FROM: ASSOCIATE CHIEF COUNSEL
CC:ITA

SUBJECT: Meal & Entertainment Refund Claim Based Upon a Statistical Sample

This Chief Counsel Advice responds to your memorandum dated August 31, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Taxpayer	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
A	=
B	=
C	=
D	=
E	=

ISSUE(S):

Whether a taxpayer may prepare a refund claim based on adjustments that are obtained from projecting the results of an analysis of a statistical sampling of meals & entertainment expenditures across the total population of I.R.C. § 274 meals & entertainment expense.

CONCLUSION:

I.R.C. § 274(d) provides that no deduction or credit shall be allowed with respect to meals & entertainment expenses unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statements, the amount, date, business purpose, and business relationship of each separate expenditure for meals & entertainment. Therefore, in order to claim a deduction or credit for meals & entertainment expenses under either I.R.C. §§ 162 or 212, the taxpayer must maintain and produce such substantiation that is proof of each expenditure for meals & entertainment.

FACTS:

During Years 1 through 5, Taxpayer used an accounting system that applied the 50% limitation of section 274(n)(1) to its year-end total of the meals & entertainment account. Under the applicable provisions of the Code, not all meals & entertainment expenses are subject to the 50% limitation; some are fully deductible as ordinary and necessary business expenses under section 162. Taxpayer believes it improperly posted some fully deductible meals & entertainment expenses to the 50% limitation meals & entertainment account.

Taxpayer estimates there were more than 50,000 meals & entertainment items posted to the subject account during year 1 alone, for which it reported a deduction for meals & entertainment expense of $A. Likewise, Taxpayer claimed meals & entertainment deductions at 50% for expenses posted to the subject account of $B for year 2, $C for year 3, $D for year 4, and $E for year 5.

Taxpayer contends that individually, the items in the account are relatively small in amount, and most of the items were in fact properly subject to the 50% limitation rule under section 274(n)(1). Notwithstanding that, Taxpayer claims it understated its meals & entertainment expense deduction by 50% of all meals & entertainment items improperly posted during years 1 through 5.

Taxpayer now wants to amend the affected returns to reflect the correct deduction amount for meals & entertainment, but the problem presented by its proposed claims involves how to identify the improperly posted items in a cost-effective manner. Moreover, Taxpayer believes any adjustments to meals & entertainment expense to which it is probably otherwise entitled likely will not justify the cost it would incur if it were to review the entire meals & entertainment population and assemble all of the necessary documentation with respect to the meals & entertainment items found to be improperly subject to the 50% limitation.

In light of that dilemma, Taxpayer has proposed to use a statistical sample of the total population of meals & entertainment items for each year to determine a percentage of the items improperly posted, then extrapolate that percentage to the entire population for the year to derive at the adjustment to the meals & entertainment deduction. Taxpayer contends the proposed sampling methodology is valid, satisfies the requirements of IRM and would achieve a 98% confidence level. Finally, the taxpayer relies on LGM TL-97 (9/9/92), Use of Statistical Sampling Techniques in Examination of Tax Returns, as support for the use of sampling in this case. Specifically, Taxpayer cites the following statement:

> The validity of statistical sampling as a tool is a twin sided issue: both the Service and the taxpayer rely on sampling. We must be careful in attacking taxpayer use of sampling procedures in general; that is, as a policy, we should be supportive of sampling as a valid measurement of the impact of all similar tax records. (Id. at p.1.)

LAW AND ANALYSIS:

I.R.C. § 274(d) imposes strict substantiation requirements for meals and entertainment expenses. The regulations thereunder clarify these stringent substantiation requirements:

> For the taxable years beginning on or after January 1, 1986, no deduction or credit shall be allowed with respect to –
>
> (1) Traveling away from home (including meals and lodging),
>
> (2) 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, including the items specified in section 274(e),
>
> (3) Gifts defined in section 274(b), or
>
> (4) Any listed property (as defined in section 280F(d)(4) and Temp. Treas. Reg. § 1.280F-6T(b)),
>
> unless the taxpayer substantiates each element of the expenditure or use (as described in paragraph (b) of this section) in the manner provided in paragraph (c) of this section.

Temp. Treas. Reg. § 1.274-5T(a).

Paragraph (b) provides that section 274(d) and the regulations "contemplate that no deduction or credit shall be allowed . . . unless the taxpayer substantiates the requisite elements of each expenditure or use . . .. " Temp. Treas. Reg. § 1.274-5T(b)(1). With respect to meals and entertainment, a taxpayer must substantiate each of the following elements: the amount of the expense, the time and place where it was incurred, the business purpose of the expense and, in the case of entertainment, the business relationship to the taxpayer of each person entertained. Temp. Treas. Reg. § 1.274-5T(b)(2)-(3).

Paragraph (c) provides that each element must be substantiated by adequate records or by sufficient evidence corroborating the taxpayer's own statement. Temp. Treas. Reg. § 1.274-5T(c)(1). The "adequate records" standard requires that a taxpayer maintain an account book, diary, log, statement of expense, or other similar record in which entries of expenditures are recorded at or near the time of expenditure. Temp. Treas. Reg. § 1.274-5T(c)(2). In addition, the taxpayer must also supply documentary evidence, such as receipts, paid bills, or similar evidence, which, in combination, are sufficient to establish each element of an expenditure or use. Id.

If a taxpayer is unable to establish that he has at least substantially complied with the adequate records standard with respect to an element of an expenditure, the taxpayer must establish the element by his own statement and other corroborative evidence. Temp. Treas. Reg. § 1.274-5T(c)(3)(i).

The use of close approximations or estimates to substantiate certain business expenses was approved in Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930). In Cohan, the taxpayer was an accomplished playwright, director and actor. Id. During the productions of his plays, he traveled extensively and often entertained actors, employees and dramatic critics. Id. at 543. It was apparent that he had paid substantial sums on such expenses but did not maintain any records or accounts. On his income tax returns, the taxpayer claimed nearly $55,000 in travel, meals and entertainment expense deductions over a three-year period, which the Service disallowed. Although the Board of Tax Appeal estimated that the taxpayer did incur at least $11,000 in such expenses, it upheld the disallowance due to a lack of substantiation. Id. The appeals court ruled that the Board of Tax Appeal erred by refusing to allow any part of the deductions, holding that absolute certainty in such matters was usually impossible and unnecessary, and "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." Id. at 543-44.

In the aftermath of Cohan, taxpayer abuse of travel, entertainment, and similar expense accounts increased greatly. Taxpayers would often overestimate the amount of the expense or assign dubious business purposes to what were essentially personal entertainment or travel expenditures. In response, Congress acted to overrule, with respect to such expenses, the so-called Cohan rule by narrowing the class of entertainment and travel expenses deductible under section 162, and establishing strict substantiation requirements for all such expenses. Dowell v. U.S., 522 F.2d 708, 711-12, cert. denied, 426 U.S. 920 (1976) (noting H. Rep. No. 1447, 87th Cong., 2d Sess., at 23 (1962-3 C.B. at 427); S. Rep. No. 1881, supra, at 35 (1962-3 C.B. at 741, U.S. Code Cong. & Admin. News 1962, p.3337)). Moreover, the regulations make it clear that for purposes of travel (including meals and lodging), entertainment, gifts, and listed property, the substantiation requirements of section 274(d) are strictly applied, and expressly prohibit the use of estimates such as that found in Cohan.

Temp. Treas. Reg. § 1.274-5T(a).

In Dowell, one of the first cases to test the new substantiation requirements, the court examined the legislative history and concluded that "section 274(d) requires taxpayers to substantiate – either through adequate records or through their own statements corroborated by other evidence – each and every element (amount, date, place, business purpose, and business relationship) of each and every expenditure in order to claim entertainment and travel expenses allowed under sections 274 and 162. If such substantiation is lacking, the deduction is to be disallowed entirely." Id. at 714 (both emphases added). The trial court in Dowell had determined that in light of "a virtual blizzard of bills, chits and other papers" relating to the taxpayer's expenses, that those elements for which adequate records had not been provided, namely the business purposes and relationship of those entertained, had been adequately substantiated by his own testimony as corroborated by the oral testimony of some 20 witnesses. Id. The court rejected that determination stating that the trial court "misapprehended the specificity with which a taxpayer must substantiate each expenditure deducted under section 274(d)." Id. The court further noted that it was apparent the lower court "was snowed under by the volume of paper in evidence and chose not to wade through it to make an expenditure-by-expenditure determination, instead making a general determination that the deductions were substantiated. Yet, this is just what § 274(d) requires the District Court to do. A less stringent examination would echo the approach under the former Cohan rule and clearly defeat the purpose of § 274(d)." Id.

Subsequent cases also have concluded that taxpayers must produce adequate substantiation for each item of travel and entertainment expenditures deducted, otherwise it will be disallowed entirely. See Yoon v. Comm'r, 135 F.3d

1007, 1016 (5th Cir. 1998) (schedules of credit card charges prepared by accountant were not reliable and did not support treatment of travel and entertainment expenses as deductible business expenses); Meridian Wood Products Co., v. U.S., 725 F.2d 1183, 1185 (9th Cir. 1984) (entertainment expenditures recorded in check registers with supporting papers, nevertheless failed to indicate the business purpose of an expenditure, the person entertained, and the date of each expense).

The regulations provide limited exceptions to the strict substantiation requirements of Temp. Treas. Reg. § 274(d). Temp. Treas. Reg. § 1.274-5T(c)(4) provides an exception for exceptional circumstances, i.e., where the inherent nature of the situation prevents the taxpayer from obtaining adequate records or other sufficient evidence. This exception requires corroboration by evidence possessing the "highest degree of probative value possible under the circumstances." Id. An exception for loss of records due to circumstances beyond the taxpayer's control is provided in Temp. Treas. Reg. § 1.274-5T(c)(5). This exception applies to loss of records by fire, flood, earthquake, or similar casualty. In that case, the taxpayer will be allowed to substantiate a deduction by reasonable reconstruction of his expenditures or use. Id. Similarly, the taxpayer may be able to use a standard allowance method to account for meals while traveling away from home in lieu of substantiating the actual costs of meals. Temp. Treas. Reg. § 1.274-5(j). However, the taxpayer will not be relieved of the requirement to substantiate the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. Id. Finally, an undue burden on the taxpayer in meeting section 274(d) substantiation requirements is not an exception. See e.g., Perfetti v. Comm'r, 762 F.2d 638, 641 (8th Cir. 1985), rev'd on other grounds, (in upholding the disallowance of travel expenses under section 274(d), the court rejected the taxpayer's argument that it would have been an undue burden for him to record the exact amount of each item).

Turning to the instant case, we do not believe a statistical sampling approach to substantiate meals and entertainment expenditures satisfies the strict substantiation requirements of section 274(d). Irrespective of the actual validity of the proposed methodology, sampling is nonetheless a form of a close approximation, the application of which is expressly prohibited by the regulations. There is no debate that sampling is used to make a general determination as to the whole population based on a review of a small group within the population. However, the specificity with which the taxpayer must substantiate each and every item covered under section 274(d), requires an expenditure-by-expenditure determination, and not a general determination that the deduction was substantiated. See Dowell, supra. Likewise, the fact that the taxpayer cannot justify the costs it would incur to meet the strict requirements of section 274(d), is not an exception contemplated under the statute or the regulations.

We believe that statistical sampling of meals and entertainment expenses as a means to estimate a claim for refund in light of the strict substantiation requirements of section 274(d) and the regulations thereunder is not permissible. Further, we believe a court would apply the reasoning outlined in Dowell, supra, in the government's favor. In our view, irrespective of the sampling methodology proposed, the substantiation requirements of section 274(d) are statutory and must be met with respect to each and every expenditure claimed. It is appropriate for the Service to expect that the taxpayer will maintain and produce substantiation as will constitute clear proof of each and every expenditure for meals and entertainment.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In light of the fact that Exam does not seem to be questioning the substantiation of the Taxpayer's items included in the section 274(n) account, it appears that the Taxpayer is only trying to prove that a certain percentage of the account is not governed by section 274(d).

The section 274(d) substantiation requirements do not apply to those items which are specifically excepted from section 274(a) under section 274(e), including expenses described in section 274(e)(1) relating to food and beverages for employees, section 274(e)(2) relating to expenses treated as compensation, section 274(e)(7) relating to items available to the public, and section 274(e)(8) relating to entertainment sold to customers, and expenses described in section 274(e)(4) relating to recreational, etc., expenses for employees. Temp. Treas. Reg. § 1.274-5T(c)(7)(i), (ii).[1]

If the taxpayer is proposing to use statistical sampling not to substantiate the actual expense, but only to prove what percentage of the entries in the meals and entertainment account are excepted from section 274, then statistical sampling, in this particular instance, does not seem prohibited by the Code or its corresponding regulations. However, in general, on a case by case basis, it is within the discretion of the Service to determine whether or not a taxpayer should be allowed to use statistical sampling techniques. The IRM states that "every examiner must determine the appropriate amount of evidence to accumulate and establish the proper depth of the examination. This decision is a matter of judgment and important because of the prohibitive cost of examining and evaluating all available

[1]Note that the regulation has not yet been updated to reflect the renumbered paragraphs in section 274(e).

evidence." I.R.M. 4.2.3.1. The IRM further states that the depth of the examination of the taxpayer's books and records can be expanded or contracted as the examination progresses and should include sampling techniques when there are voluminous records. I.R.M. 4.2.3.5. Thus, the Service has discretion to determine the extent of the examination that will be conducted on the taxpayer's supporting documents and the extent of the evidence needed to be provided by the taxpayer in order to support the taxpayer's claims. Therefore, it is within the discretion of the Service to determine whether or not a taxpayer should be allowed to use statistical sampling techniques.

Taxpayer's reliance on LGM TL-97, regarding the use of statistical sampling techniques in examination (or auditing) of tax returns, is misplaced. In LGM TL-97, the Service advised that the validity of statistical sampling methods employed in the audit of tax returns would be upheld in court. In that context, sampling is used only as an audit procedure or tool to examine or review "a group of accounting entries or transactions" where "the totality of all such transactions is prohibitive in terms of time and resources." The use of statistical sampling as an audit procedure with respect to income tax returns is analogous to using statistical sampling in the context of auditing financial statements. As such, a brief review of the nature and purpose of audit sampling in the financial statement context may be illustrative. Statement on Auditing Standards (SAS) No. 39, Audit Sampling, provides guidance on the use of sampling (statistical and non statistical) in an audit of financial statements. AICPA Audit and Accounting Guide, Vol. 1, Audit Sampling (AAG-SAM), p.1,011, ¶ 1.01 (1995). Under SAS No. 39, audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class, and generally functions as a means to gather audit evidence. Id. at p.1025, ¶ 2.01. The use of sampling in accounting populations differs from other populations because before the auditor's testing begins, the data have been accumulated, compiled, and summarized. As such, rather than using the sample to estimate an unknown, the auditor's objective is generally to corroborate the accuracy of certain client data, such as data about account balances or classes of transactions. Id. at pp.1026-27, ¶ 2.09. The audit process is generally an evaluation of whether an amount is substantially correct rather than a determination of original amounts. Id.

Regarding the use of statistical sampling in general, the Service has already demonstrated its support for the use of statistical sampling through its own reliance on statistical sampling in large case examinations to reduce the financial and time burdens of examining voluminous accounting data. [redacted]

[redacted]

Even if the Service allows certain large taxpayers to use statistical sampling, the Service should always review the taxpayer's statistical sampling techniques and challenge a particular sampling technique if the technique is not accurate, appropriate, or reliable. If the Service should decide to allow taxpayers to use statistical sampling in the preparation of tax returns in general, the Service should also require the taxpayer to follow the same statistical sampling requirements that the Service is required to follow by I.R.M. 42(18)4.1, 42(18)4.2, and 42(18)4.3. The I.R.M. requirements will help to ensure the accuracy of the taxpayer's statistical sampling technique.

If the Service allows large taxpayers to use statistical sampling, the Service needs to clarify with the large taxpayers using statistical sampling that statistical sampling would not affect any of the record keeping requirements within the Code. Taxpayers would still be required to fully maintain all records. Statistical sampling would only affect the number of records required to be analyzed in order to verify the taxpayer's tax liability.

Finally, there may be an issue whether Taxpayer's proposed treatment to reflect the proper account balances previously recorded for its meals and entertainment (i.e., by filing a claim for refund) is an impermissible retroactive change in accounting method. A detailed discussion of this issue is outside the scope of this FSA.

Please call (202) 622-4970 if you have any further questions.

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