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Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

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TAX ADMINISTRATION

Recurring Issues in Tax Disputes Over Business Expense Deductions

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General Government Division

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September 26, 1995

The Honorable Nancy L. Johnson
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Chairman Johnson:

Every year the Internal Revenue Service (IRS) audits the tax returns of over one million taxpayers, adjusting the tax liability of taxpayers who IRS believes do not comply with provisions of the Internal Revenue Code (tax code). Taxpayers may challenge IRS' proposed adjustments by filing a protest with the IRS Office of Appeals or filing a petition with the U.S. Tax Court.

Former Chairman J.J. Pickle asked us to identify the issues that caused the most frequent disputes between IRS and taxpayers in connection with section 162 of the tax code. Section 162 allows taxpayers to deduct from income "ordinary and necessary" expenses related to trade or business. We had previously reported that section 162 was the tax code section most commonly cited in large tax cases at the IRS Office of Appeals.[1]

To do the requested analysis, we reviewed 185 Tax Court petitions filed in 1993,[2] mostly by sole proprietors and small and medium-sized corporations, as well as partnerships, individual shareholders, and individuals claiming employee business expenses. We also reviewed 117 Office of Appeals cases filed by large corporations.[3]

Results in Brief

In the 185 Tax Court petitions we reviewed, sole proprietors, small and medium-sized corporations, and individuals claiming employee business expenses disagreed with IRS most frequently over the adequacy of documentation for a given expense deduction. About 47 percent of all the

[1]Tax Administration: Recurring Tax Issues Tracked by IRS' Office of Appeals (GAO/GGD-93-101, May 4, 1993). This report identified sections of the tax code that were the frequent subjects of large cases in the Office of Appeals.

[2]We used 1993 petitions because this was the only year where all data, including an index identifying the tax code sections in dispute, were available.

[3]By large corporations, we mean the 1,700 largest corporations that IRS audits under a special program, the Coordinated Examination Program. The 117 cases also included any cases where the proposed tax adjustments exceeded $10 million, regardless of corporate size, plus some cases where the proposed adjustment was between $1 million and $10 million and where the issue in the case was one tracked by IRS in its Appeals Coordinated Issue Program or its Industry Specialization Program. The 117 large cases were in the Office of Appeals' open inventory as of September 1994.

issues in the petitions we reviewed involved questions of proper documentation. These disputes were especially frequent where the documentation requirements were the most rigorous—entertainment, travel, meals, and automobile expenses. This rigor comes about because section 274 of the tax code adds other evidentiary tests to the ordinary and necessary standard.

While documentation was the issue sole proprietors disputed most frequently, small and medium-sized corporations contested IRS' decisions on the reasonableness of executive salaries as frequently as they did documentation. Under the tax code, a taxpayer may only deduct a "reasonable allowance" for salaries. IRS generally challenges closely held corporate[4] taxpayers when their salaries appear excessive.[5]

Overall, the frequency of disputes over unreasonable executive compensation was far less than disputes involving documentation of business expenses—14 percent versus 47 percent. However, executive compensation accounted for about 50 percent of the total proposed tax adjustments—$24.5 million of $48.8 million—in the petitions we reviewed. Adequacy of documentation was the second largest category at $9.3 million. (See app. I for more information about the issues in dispute in the petitions we reviewed.)

In the 117 Office of Appeals cases, large corporate taxpayers disagreed with IRS most frequently over the issue of capital expenditures, which accounted for about 42 percent of the issues they contested. It was also the issue with the most dollars at stake in the 117 cases, accounting for $1.1 billion of the total $1.9 billion in proposed tax adjustments. In these cases, the corporations argued for immediate deduction of large expenses related to events such as corporate mergers, reorganizations, or environmental cleanups. IRS contended that such expenditures had future benefits and should therefore be treated as capital expenditures, not immediately deductible in the current tax year.[6]

[4]"Closely held corporations" are privately owned corporations with a relatively small number of shareholders.

[5]In the cases of closely held corporations, IRS almost always argues that any amount of salary considered excessive is a "disguised dividend"—a distribution of profits. Corporations may deduct salaries as business expenses but no deduction is available for dividends.

[6]Costs of capital expenditures are added to the basis of the property involved in the transaction. Depending on the property, the costs are generally either depreciated over a period of years or used to reduce the gain on the disposition of the property. Therefore, if capital improvements are made to a building, these may be depreciated over the life of the building. However, if capital improvements are made to land, the tax benefit is obtained only when the owner disposes of the land.

All of the other issues the large corporations disputed were contested far less frequently than the issue of capital expenditures. Documentation questions accounted for only 8 percent of the issues contested. Unreasonable executive compensation accounted for 3 percent of the issues and 1 percent of the proposed adjustments. (See app. II for more information about the issues in dispute in the Office of Appeals cases we reviewed.)

Background

Section 162 of the tax code allows taxpayers to deduct from income ordinary and necessary expenses related to a trade or business. Taxpayers report these deductions to the IRS in various ways on their tax returns.

When IRS audits taxpayers, it frequently challenges deductions of business expenses as not being in compliance with section 162. As we reported in May 1993, section 162 was the code section most commonly cited in large tax cases at the Office of Appeals.

When taxpayers disagree with IRS' audit findings, IRS advises them by letter that they have 30 days in which to file a protest requesting a conference with the IRS Office of Appeals. If the taxpayer and the Office of Appeals cannot reach an agreement or if the taxpayer waives the right to an Office of Appeals conference, IRS issues a statutory notice of deficiency, a so-called "90-day" letter. On receipt of the letter, taxpayers have 90 days in which to petition the Tax Court for relief.

The Tax Court notifies IRS when it receives a taxpayer's petition, and the Office of Appeals generally has the authority to settle the case at any time before the scheduled court trial. When the Office of Appeals has previously dealt with the petitioner, IRS' Office of the Chief Counsel assumes jurisdiction over the case. According to the Office of Appeals, roughly 90 percent of all its cases are settled administratively without court litigation.

In fiscal year 1993 and again in fiscal year 1994, the Office of Appeals received over 65,000 cases for settlement. Approximately two-thirds of these cases came from protests filed directly with the Office of Appeals, while the remaining one-third originated with petitions filed with the Tax Court.

Objective, Scope, and Methodology

Our objective was to identify the types of disputes commonly occurring between taxpayers and IRS under section 162 of the tax code. We defined disputes as cases where the taxpayers protested to IRS' Office of Appeals or petitioned the Tax Court. We realize that taxpayers may disagree with IRS' proposed adjustments but not file protests or petitions. However, there is no practical way for us to define such a universe to review. Except for its largest cases, IRS does not routinely track recurring issues in taxpayer cases. For its Large Case Program, which involves the largest corporate taxpayers or tax adjustments exceeding $10 million, the Office of Appeals maintains an issue tracking system, CENTAUR. Our May 1993 report on recurring tax issues focused on issues in the large tax cases and used data from CENTAUR. In this report, we included large cases but also expanded our review to include IRS' disputes with smaller businesses and individuals by using information from 1993 Tax Court petitions.

To create our sample of Tax Court cases, we used a database of 1993 Tax Court petitions and an index to these petitions, both of which were published by Tax Analysts.[7] This index identified 795 petitions filed in 1993 involving section 162. To determine the most frequently recurring reasons for disputes, we obtained all 226 petitions filed between January 1 and May 17, 1993, and other documents filed with the petitions. Although these petitions were filed during the January through May time period, the dates they were filed did not determine the issues that were contested. Because of this random nature, we have no reason to believe the issues in these petitions would differ from issues contested at other times during 1993.

However, we were unable to use all 226 petitions. For 41 petitions, the information was insufficient for us to categorize the reasons (e.g., documentation, executive compensation) for the disputes. Our results are from the remaining 185 petitions in which the information was sufficient.

We examined CENTAUR data to identify the most frequent section 162 issues in large tax cases. For the CENTAUR system, which tracks appealed cases, IRS personnel classify the major issues in each case and summarize the dispute. We reviewed data for all 117 cases that were from IRS' western and southeast regions and in an "open" status as of September 1994. We judgmentally selected these two regions on the premise that the types of large corporations located in each, and therefore

[7]Tax Analysts, a private company, routinely publishes texts of petitions and other documents filed with the Tax Court in connection with its publication Tax Practice & Controversies. In April 1994, Tax Analysts also published Index to U.S. Tax Court Petitions and Complaints Filed in the Court of Federal Claims and the 94 U.S. District Courts During 1993. This publication provides an index of taxpayers' petitions by tax code section.

the issues they may contest, would differ. We thought that such differences would give us a better cross section of the issues large corporations dispute.

In reviewing the 185 Tax Court cases and the 117 Office of Appeals cases, we did not assess whether the taxpayer or the IRS was correct in the position they took on the issues. Neither did we ascertain how the cases were resolved.

We asked IRS' Office of Examination and Office of Appeals to review our preliminary results. In responding to our request, the Office of Examination reviewed its database on issues in the Coordinated Examination Program, and the Office of Appeals reviewed its CENTAUR database. Both of the offices developed findings that were generally similar to ours.

We did our work in Washington, D.C., and Laguna Niguel, CA, between August 1994 and March 1995 in accordance with generally accepted government auditing standards.

We requested comments on a draft of this report from the Commissioner of Internal Revenue or her designee. We met with IRS National Office officials to obtain their comments on August 18, 1995. IRS representatives at that meeting included the Office of Appeals' Director of Large Case Programs and the Office of Examination's National Directors of the Office of Corporate Examination and the Office of Compliance Specialization. The IRS officials agreed with the information presented in this report.

We are sending copies of this report to congressional committees with an interest in or jurisdiction over tax matters, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. Copies will be made available to others upon request.

The major contributors to this report are listed in appendix III. Please contact me on (202) 512-8633 if you or your staff have any questions.

Sincerely yours,

Lynda D Willis

Lynda D. Willis
Associate Director, Tax Policy
and Administration Issues

Contents

Abbreviations

IRS	Internal Revenue Service

Frequent Issues in Tax Court Petitions Filed Primarily by Sole Proprietors and Smaller Corporations Over Section 162 Business Deductions

We reviewed 185 petitions filed with the U.S. Tax Court between January and mid-May 1993 in which taxpayers contested IRS' findings on business deductions they took under section 162 of the tax code.[1] The petitions involved tax returns for tax years ranging from 1979 to 1991. The most common tax years were 1988, 1989, and 1990, which altogether accounted for 75 percent of the tax years.

The 185 taxpayers who filed the petitions were primarily sole proprietors (51 percent of the 185 taxpayers) and small and medium-sized corporations (31 percent). Other petitioners were partnerships, individual shareholders, and individuals claiming employee business expenses.

Most Common Issues Overall

To identify and classify the issues in the Tax Court petitions, we reviewed the petitions and their attached documents. The petitions contained 221 issues in connection with section 162, and the issues fell into 6 categories.

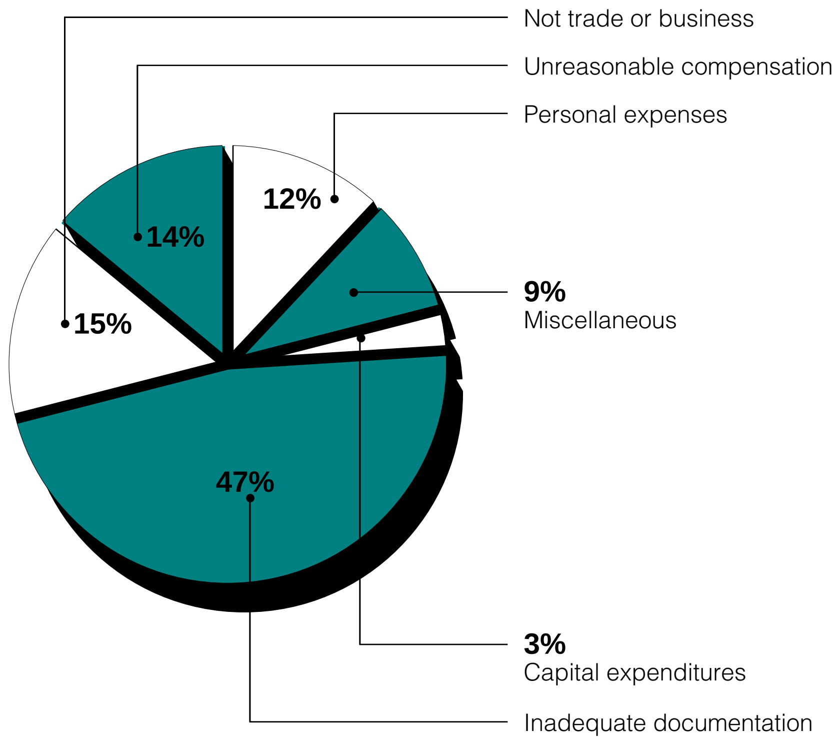
- Inadequate documentation. These issues involved instances where, according to IRS, the taxpayer did not (1) provide documentation for an expense claimed on a tax return or (2) have all of the documentation necessary to deduct a particular type of expense.
- Unreasonable compensation. These issues involved closely held corporations that, according to IRS auditors, deducted more than was "reasonable" for an officer's salary or, in some cases, rental property owned by the corporation's officers. IRS classified the excessive amount as a "disguised dividend" to the shareholder/officer receiving the salary or the rent and thus taxable as corporate or individual income.
- Not trade or business. These issues included a variety of circumstances where the taxpayer claimed deductions as a profit-making trade or business. IRS disallowed the deductions, asserting that the taxpayer was not engaged in a profit-making trade or business. The variety of circumstances included
  - "hobby" cases where the taxpayer deducted expenses for what IRS considered to be a recreational activity,
  - cases where the taxpayer carried on investment activity that IRS said was not an actual "trade," and

[1]We excluded from the petitions we reviewed any petition filed by a corporation in the IRS' Coordinated Examination Program, which covers the 1,700 largest corporations in the United States. We refer to the remaining corporations—those that filed petitions but were not among the 1,700 largest corporations—as small and medium-sized corporations or, at times, "smaller" corporations. We also excluded petitions where the amount in controversy exceeded $10 million regardless of corporate size. Issues involving the largest corporations and dollar disputes are discussed in appendix II.

  - cases where the taxpayer claimed business deductions as an independent contractor that IRS disallowed because it considered the taxpayer to be an employee rather than an independent contractor.
- Personal expenses. For the issues in this category, the taxpayer could document an expense but the IRS auditor concluded that the expense was a nondeductible personal expense, such as the cost of residential rent, residential utilities, or life insurance premiums.
- Capital expenditures. In these issues, the taxpayer deducted the entire amount of a business expense but IRS said the expense (a major repair, for example) had a future benefit and should be treated as a capital expenditure.
- Miscellaneous. This category included issues such as taxpayers claiming business deductions that exceeded a statutory limit on the particular type of expense, claiming deductions properly taken by another taxpayer, and deducting expenses that IRS auditors termed nondeductible fines or penalties.

Of the six categories, inadequate documentation was the issue taxpayers most frequently disputed. Figure I.1 shows the frequency of the six issues.

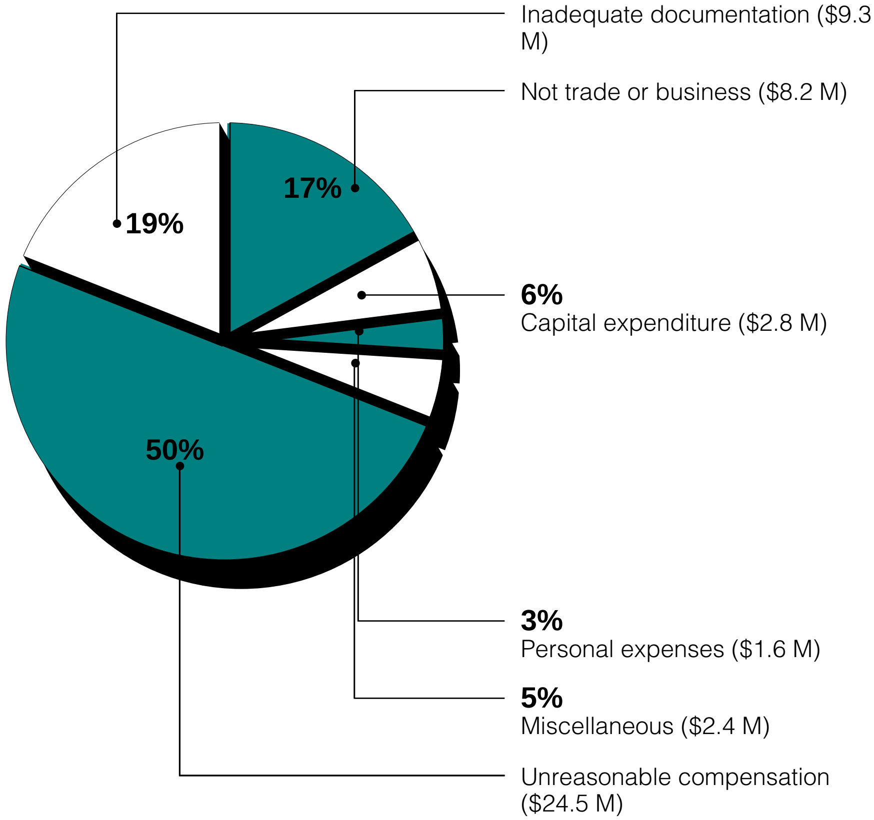
Figure I.1: Frequency of Issues in Petitions Filed by Individuals, Partnerships, and Smaller Corporations



Source: GAO analysis of petitions filed with the U.S. Tax Court.

Figure I.2 shows IRS' proposed tax adjustments, which totaled $48.8 million, for the 221 issues. One issue—unreasonable compensation—accounted for 50 percent, or $24.5 million, of the total proposed adjustments. All of the other categories accounted for considerably smaller percentages of the total.

Figure I.2: Proposed Tax Adjustments by Issue



Source: GAO analysis of petitions filed with the U.S. Tax Court.

Issue of Inadequate Documentation Often Connected to Tax Code Section 274

The business deductions challenged by IRS for lack of adequate documentation included a wide variety of business expenses, such as advertising and insurance costs, but most often involved expenses—entertainment, meals, travel, and automobile—that are specifically addressed in section 274 of the tax code. Over 40 percent of the petitions we reviewed, where documentation was an issue, included some dispute over a deduction covered by section 274. Expenses under section 274 must meet more rigorous documentation requirements to be deductible as business expenses than other expenses generally deductible under section 162.

To deduct entertainment expenses, for example, a taxpayer must show not only that the expense is ordinary and necessary in the taxpayer's trade or business but also that the expense is directly related to or associated with the taxpayer's business. For instance, one corporate taxpayer in the petitions we reviewed had over a dozen season tickets to all events at a major civic center, and the taxpayer deducted the cost of those tickets as entertainment expenses. IRS disallowed most of the entertainment expenses because, according to the IRS auditor, the taxpayer could not substantiate the business purpose of that many tickets and guests. To meet the requirements of section 274, the taxpayer had to show (1) that the cost of the tickets was ordinary and necessary to the corporation's business and (2) that there was a business connection with each ticket and guest.

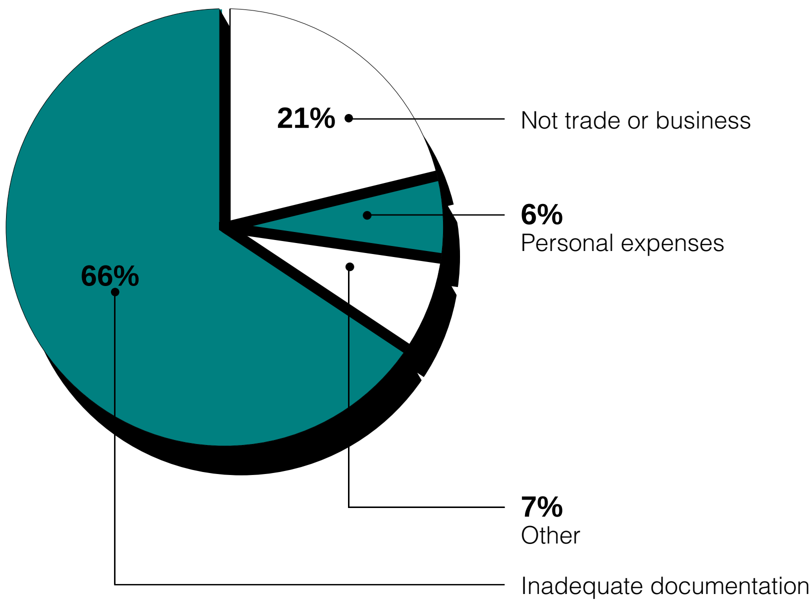
Beyond rigorous requirements for documentation of business purpose, section 274 has special rules related to certain entertainment and travel expenses. To deduct costs of a country club facility, for example, a taxpayer must show that the club was used "primarily" to further the taxpayer's business and that the item was directly related to the conduct of the trade or business. Thus, in one petition, a taxpayer who worked part-time as an insurance salesman and deducted costs of membership in a country club as a business expense, complained that IRS had not properly considered his business log showing that he regularly entertained clients at this club. However, IRS had disallowed his club expenses because it believed that he failed to show that over 50 percent of the club use was for business purposes.

Among the petitions we reviewed, documentation of automobile and travel expense were the most frequent sources of dispute. As an example, one corporate taxpayer incurred expenses for usage of automobiles by employees, including some of its shareholders and officers. IRS reduced the taxpayer's deduction by over $14,000, limiting it to the amount directly related to the total miles driven for business purposes. At the same time, IRS disallowed over $19,000 in travel and entertainment expenses because the taxpayer failed to furnish sufficient documentation.

Most Common Issues in Petitions Filed by Sole Proprietors

Sole proprietors—those taxpayers claiming business deductions on schedule C of their personal income tax returns—filed the largest percentage of the Tax Court petitions we reviewed, about 51 percent. Figure I.3 shows the issues most prevalent among sole proprietors; two-thirds of the disputes were over proper documentation of business expenses.

Figure I.3: Frequency of Issues in Petitions Filed by Sole Proprietors



Source: GAO analysis of petitions filed with the U.S. Tax Court.

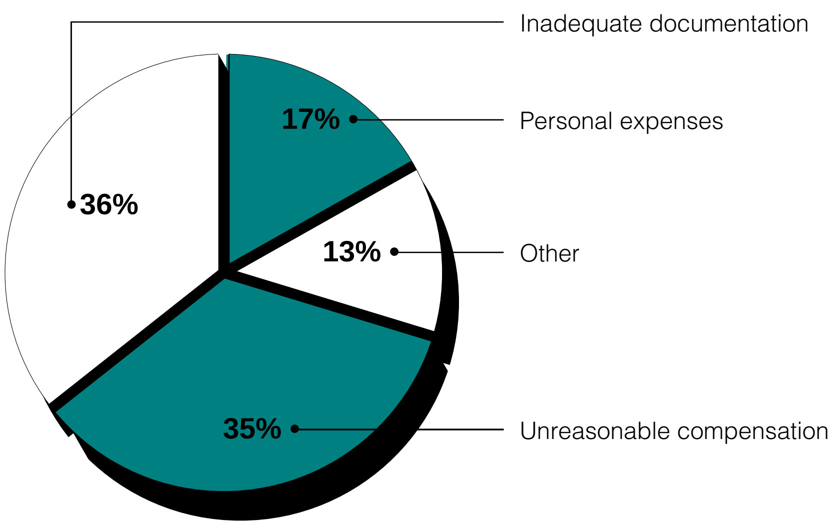
Most Common Issues in Petitions Filed by Small and Medium-Sized Corporations

At 31 percent, small and medium-sized corporations filed the second largest percentage of Tax Court petitions that we reviewed. As seen in figure I.4, among corporate taxpayers, disagreements with IRS over the amounts corporations paid their executives were almost as numerous as disputes over the sufficiency of expense documentation. Since the Revenue Act of 1919,[2] IRS has had the authority to determine whether the

[2]Chapter 18, 40 Stat. 1057, Section 214(a) and Section 234(a).

amount of compensation paid to a corporate official and claimed as a business expense is “reasonable.”

Figure I.4: Frequency of Issues in Petitions Filed by Smaller Corporations



Source: GAO analysis of petitions filed with the U.S. Tax Court.

For the most part, IRS raised the issue of unreasonable compensation in audits of closely held corporations. Where IRS auditors find a corporate officer’s salary to be excessive in amount, the auditors generally argue that the excessive amount is distribution of the profits, not compensation for services rendered. Nearly all taxpayers petitioning on this issue were closely held corporations with only a small number of shareholders. On average, the proposed tax adjustment for the compensation issue was higher than other adjustments—$817,000. In contrast, the average proposed tax adjustment for issues involving documentation was $89,000. Examples of the compensation issue follow.

A corporation paid its president (and sole shareholder) an average of about $700,000 in each of 3 successive years. IRS auditors compared the president’s salary with that of others in the firm, with comparable salaries in other similar businesses, and with compensation practices outside of the taxpayer's industry. On the basis of these comparisons, the auditors asserted that the company overpaid its president by about $400,000 each year and proposed an adjustment of over $1,200,000 to the corporation's tax liability.

In another case, an individual bought the controlling interest in a closely held corporation and set himself up as the firm's chief executive officer. However, he had a number of businesses in other states, and he let the corporate president manage the daily affairs of the corporation. The corporation paid the chief executive officer and controlling shareholder an average of $300,000 for several years. IRS auditors concluded that the chief executive officer was an absentee owner paying himself profits rather than compensation on services rendered, and the auditors proposed a tax adjustment of over $1 million.

IRS will consider other factors, particularly salary history, to determine reasonable compensation. In one case, two men set up a firm to do military contract work in the mid-1970s. In the late 1980s, the corporation markedly increased the salary of both men, and IRS disallowed nearly $1 million for the years under review. In another case, one individual worked for a landfill business for over 20 years. In one year, the landfill corporation paid this individual several million in annual compensation. IRS disallowed all but $400,000 of this payment.

The total amount in dispute can involve payments to a number of corporate officers, all of whom IRS may have determined were paid excessive amounts. In one case, IRS disallowed $2.5 million over a 3-year period. These were compensation payments to five corporate officers.

Issues Frequently Disputed by Large Corporations or in Large Dollar Cases Involving Section 162 Business Deductions

Using data from the Office of Appeals' CENTAUR issue tracking system, we reviewed 117 cases from IRS' western and southeast regions that were open in the Office of Appeals as of September 1994. The cases involved either a large corporation[1] or tax adjustments exceeding $10 million in dispute plus some cases where the proposed adjustment was between $1 million and $10 million and the issue in the case was being specially tracked by the Office of Appeals.[2] In each case, the taxpayer was contesting an adjustment proposed by IRS under section 162 of the tax code.

Most Common Issues

CENTAUR contains a summary of the issues in each case. To identify and classify the issues in the 117 cases, we reviewed the CENTAUR summaries. We identified 219 issues that were associated with section 162. For 17 of the issues, the available information was insufficient for us to categorize the nature of the dispute. The remaining 202 issues fell into 9 categories.

- Capital expenditures. For issues in this category, the taxpayer deducted the costs associated with a corporate acquisition, merger, or reorganization or an environmental cleanup. IRS viewed these costs as capital expenditures, not deductible in the current tax year.
- Captive insurance. In these issues, the corporate taxpayer deducted amounts it paid to a wholly owned corporate subsidiary for an insurance policy. IRS will allow the deduction only if it determines that the payment is not "self-insurance" but rather shifts the risk of loss to another entity.
- Not trade or business. Most of the cases and proposed tax adjustments for this issue were attributable to one set of tax shelter cases. In these cases, IRS asserted that the taxpayers had not set up the business for the purpose designated but to shelter income of business investors.
- Inadequate documentation. As with the issues in appendix I, these issues involved instances where the taxpayer did not provide documentation for a claimed expense or did not have all of the documentation necessary to deduct a particular type of expense.
- Not ordinary and necessary. These issues involved instances where IRS challenged an expense that it believed was unnecessary to the corporation's business.

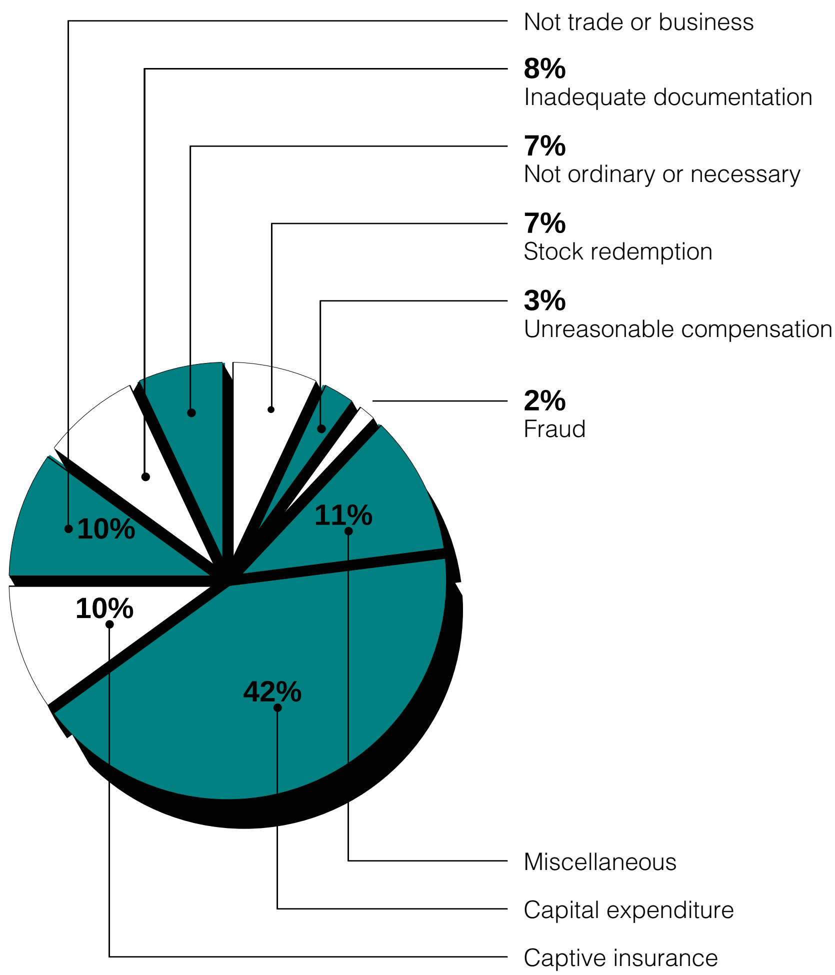
[1]For the purpose of this report, large corporations are those audited under IRS' Coordinated Examination Program, which includes the 1,700 largest corporations in the United States.

[2]The Office of Appeals tracks the issues in its Appeals Coordinated Issue Program or the Industry Specialization Program.

- Stock redemption. IRS characterized various transactions as stock redemptions in these issues. Section 162(k) of the tax code denies deductions for expenses incurred by a corporation in connection with redemption of its own stock.
- Unreasonable compensation. As with the issues in appendix I, these issues generally involved a closely held corporation that, according to IRS auditors, deducted more than was "reasonable" for an officer's salary. IRS classified the excessive amount as a "constructive dividend" to the officer/shareholder receiving the excessive salary.
- Fraud. In these issues, IRS alleged that the taxpayer deliberately altered records to support a claimed business expense.
- Miscellaneous. This category included issues of corporations deducting costs of direct lobbying or costs of fines and penalties.

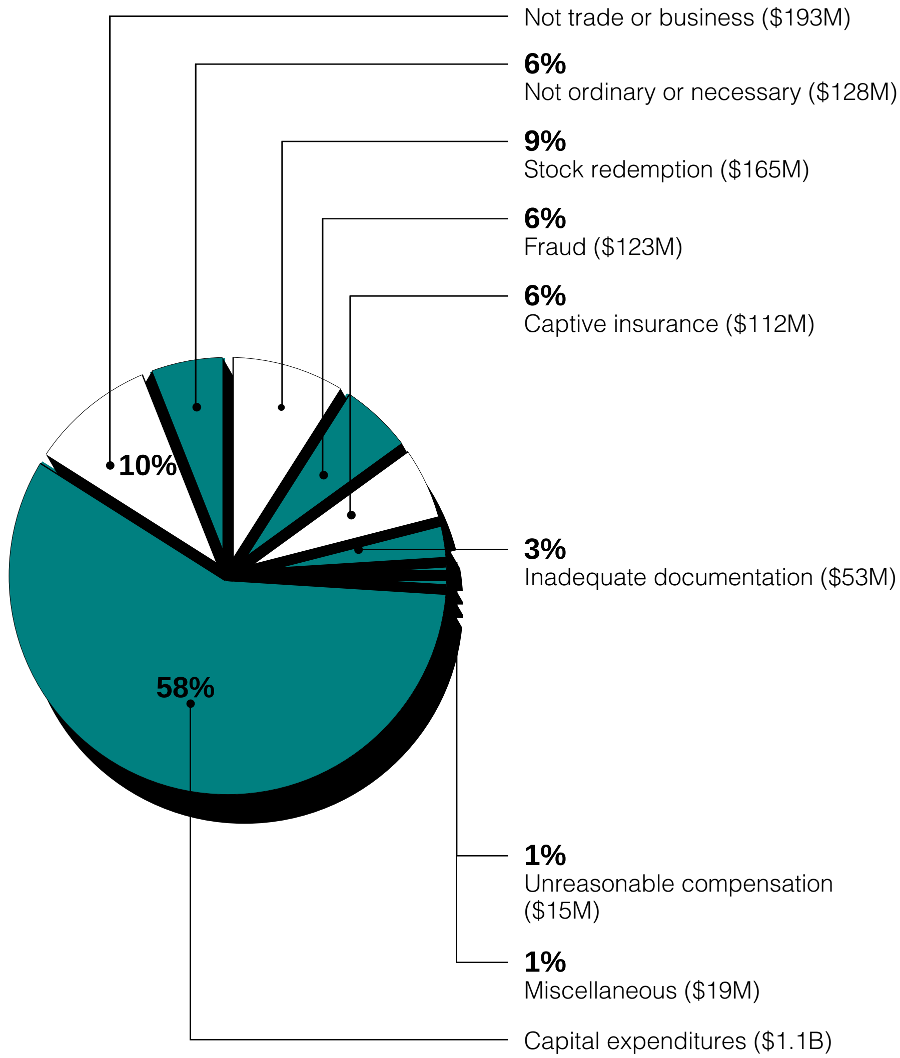
The frequency of each issue is shown in figure II.1. Figure II.2 presents IRS' proposed tax adjustments for these issues, which totaled $1.9 billion. By sizeable margin, the capital expenditure issue occurred most frequently and had the largest amount of proposed adjustments. This is unlike our sample of smaller business taxpayers discussed in appendix I, where the most frequent issue and the issue with the largest proposed adjustment were different. Further, the issues that dominated our sample in appendix I, documentation and executive compensation, are found much less frequently in this group of large corporations and cases.

Figure II.1: Frequency of Issues Disputed by Large Corporations and in Large Cases



Source: GAO analysis of IRS CENTAUR data.

Figure II.2: Proposed Tax Adjustments by Issue



Source: GAO analysis of IRS CENTAUR data.

More Information About the Capital Expenditure Issue

As figures II.1 and II.2 showed, the capital expenditure issue was predominant, accounting for about 4 out of every 10 issues and $1.1 billion of the $1.9 billion in proposed tax adjustments. Under the tax code, amounts paid for "capital expenditures" are not deductible in the current tax year as business expenses under section 162.[3] Further, section 263 of the tax code explicitly requires capitalization of expenditures for "permanent improvements or betterments."

At least 31, or more than one-third of the issues involving capital expenditures, dealt with costs associated with corporate acquisitions, mergers, and reorganizations. These costs included professional fees for legal and investment advice, financing fees, and other costs incurred in the transactions.[4] In its review, IRS tries to determine whether the transactions result in a long-term benefit to the corporation. If so, IRS' position is that the expenditure must be capitalized under section 263.

At least 16 of the capitalization issues involved questions on the costs of repair or cleanup of land, buildings, or other property. IRS examines costs related to environmental cleanups using the same test it applies to acquisition, merger, and reorganization costs. If the expenditure produces significant long-term benefits to the taxpayer, then the cost should be capitalized as a "permanent improvement or betterment" under section 263, according to IRS.

[3]Actual tax treatment of a capital expenditure varies. Generally, the expenses are added to the capital account or "basis" of the property involved in the transaction. Depending on the property, the costs of improvements may be depreciated over the life of the asset or used to reduce the amount of the gain realized on the sale of the asset.

[4]In this section, we discuss 47 of the 86 issues involving capital expenditures. The summary data in CENTAUR allowed us to identify the issue in all cases. But for 39 of the capital expenditure issues, the summary information was not sufficient to allow us to discuss the facts in the case. Many of these cases also involved costs of professional fees but the summary information did not describe the transaction.

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