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Comparative Analysis of Entertainment Expense in the United States and Korea

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Abstract

This article provides preliminary guidelines for researchers and investors who are interested in Korean tax law in the area of entertainments expenses via comparative analysis of tax laws in the United States and Korea. Unlike the U.S., Korea regulates entertainment expenses only by placing a ceiling on the deductible amount, not by imposing stricter conditions for a business deduction. In the U.S. 50 percent of any entertainment expense otherwise deductible is allowed. Korea places a ceiling on otherwise deductible entertainment expenses according to a mathematical formula. To determine which expenses qualify as entertainment expenses, Korean courts or administrative agencies apply a comparative analysis with other expenses. Under American tax law for a business deduction an entertainment expense at least should be associated with the active conduct of the taxpayer's trade or business. For a business deduction a taxpayer must substantiate entertainment expenses by evidence or documents as prescribed in the relevant provisions in the U.S. and Korea.

Key Words: business expense, entertainment expense, substantiation, business gift, directly related, associated with, ordinary expense

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I. Introduction

This article is to provide preliminary guidelines for researchers and investors who are interested in Korean tax law in the area of entertainments expenses. This article will analyze provisions of entertainment expenses of the Unites States and Korea, while comparing and contrasting relevant provisions and their interpretations.

Taxable income is calculated by subtracting deductible expenses from gross income. The *Beopinse beob*, Corporation Tax Law (CTL) of Korea uses

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an all-inclusive system to calculate taxable income, which means that all income must be included in gross income from whatever source derived. But only expenses that are permissible under tax law are deductible. In terms of permissible tax expenses, one general section, article 19 of the CTL and Internal Revenue Code (I.R.C.) §162(a) provides the conditions for deducting business expenses, and the following other individual articles disallow otherwise deductible expenses under the general section. Thus, even though some expenses are otherwise deductible under the general section, for policy reasons they may not be fully deductible. Entertainment expenses are among one of them.

The expenses of conducting a business are generally deductible, while personal expenses are not. However, some expenses, such as meals and entertainment expenses are connected with both the business and personal settings in a taxpayer's life. Thus, for a tax deduction, such expenses are required to meet stricter additional conditions. For a business deduction of entertainment related expenditures, a taxpayer must meet requirements for an entertainment expense in addition to such general provisions as the Internal Revenue Code §162(a) and article 19 of the CTL. I.R.C. §274 and article 25 of the CTL provide additional conditions for a deduction of an entertainment expense.

II. Review and Analysis of Section 274 of the Internal Revenue Code and Its Interpretation in the United States

To be deductible for tax purposes, expenditures for meals and entertainment must be "ordinary and necessary expenses" incurred or paid in carrying on the taxpayer's business or profit-oriented activities, as prescribed in I.R.C. §§162 and 212.[1)] In addition, I.R.C. § 274 limits the amount otherwise deductible under §§162 and 212. Thus, once a taxpayer has established that the expenses incurred were ordinary and necessary, the taxpayer must then show a more proximate relationship between the

1) Treas. Reg. § 1.274–1; Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 21.2.2 (3d ed. 2009).

expenditure and his trade or business.[2)]

1. Business Connection Test

I.R.C. § 274(a)(1)(A) provides that no deduction otherwise allowable is allowed for any item with respect to an activity that is generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business. For this purpose, an activity subject to I.R.C. § 212 (relating to expenses incurred for the production of income and other profit-oriented activities) is treated as a trade or business.[3)]

"Entertainment" means any activity that is generally considered to constitute entertainment, amusement, or recreation, such as entertaining at nightclubs, theaters, clubs, sporting events, and on hunting, fishing, vacation and similar trips.[4)] Entertainment also includes activities that satisfy the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family.[5)] However, entertainment does not include activities that, although satisfying personal, living, or family needs, are clearly not regarded as constituting entertainment, such as supper money provided by an employer to his employee, a hotel room maintained by an employer for employees during business travel, or an automobile used in the active conduct of a trade or business.[6)] However, providing a hotel room or an automobile by an employer to his employee, who is on vacation, would constitute entertainment of the employee.[7)]

An objective test is used to determine whether an activity is of a type

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2) Mertens, Law of Federal Income Taxation § 25D:01 (2012).

3) I.R.C. § 274(a)(2)(B).

4) Treas. Reg. § 1.274-2(b)(1)(i).

5) *Id.*

6) *Id.*

7) *Id.*

generally considered to constitute entertainment. If an activity is generally considered to be entertainment, it will constitute entertainment regardless of whether the expenditure can also be described otherwise and even though the expenditure relates to the taxpayer alone.[8] Any expenditure that might generally be considered either for a gift or entertainment or considered either for travel or entertainment, is considered an expenditure for entertainment rather than for a gift or travel.[9]

1) "Directly related" test

I.R.C. § 274 (a)(1)(A) disallows a deduction for an item with respect to an activity that is generally considered to constitute entertainment, amusement, or recreation, unless a taxpayer establishes that it was (i) "directly related to" the "active conduct" of the taxpayer's trade or business or (ii) "associated with" the active conduct of the business and directly preceded or followed a substantial and bona fide business discussion.

I.R.C. § 274(a)(1)(A) accomplishes its purpose of determining whether there is a close connection between the taxpayer's business and the expenditure in question by imposing a business connection test on certain expenditures. Under the first business connection test, to be deductible, the expenditures must be "directly related" to the active conduct of the taxpayer's trade or business. If an expenditure is otherwise deductible, it is considered directly related to the active conduct of the taxpayer's trade or business if it comes within one of the following categories:[10] (i) the active business discussion test[11] or (ii) the clear business setting test.[12]

But some expenditures for entertainment, even if connected with the taxpayer's trade or business, will generally be considered not directly related to the active conduct of the taxpayer's trade or business if the entertainment occurred under circumstances in which there was little or no possibility of engaging in the active conduct of trade or business, such as when (i) the taxpayer was not present or (ii) distractions were substantial,

8) Treas. Reg. § 1.274-2(b)(1)(ii).

9) Treas. Reg. § 1.274-2(b)(1)(iii).

10) MERTENS, *supra* note 2, at § 25D:31.

11) Treas. Reg. § 1.274-2(c)(3).

12) Treas. Reg. § 1.274-2(c)(4).

such as, for instance (a) a meeting or discussion at a night club, theater, or sporting event, or during essentially a social gathering, such as a cocktail party, or (b) a meeting or discussion, if the taxpayer meets with a group that includes persons other than business associates at places, such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts.[13)]

2) "Associated with" Test

Entertainment expenses that do not meet the directly related standard will be deductible only if they are "associate with" the active conduct of a trade or business and expenses incurred for entertainment that directly preceded or followed a substantial and bona fide business discussion.[14)] This provision was intended to permit the deduction of entertainment expenses incurred primarily for the purpose of fostering goodwill.[15)] Under this rule, business goodwill entertainment expenses at nightclubs, theaters, sporting events, or hunting and fishing trips can be deductible, if the taxpayer can show that the entertainment took place directly before or after a substantial and bona fide business discussion.[16)] But social events that do not directly precede or follow a bona fide business discussion do not qualify under this section.[17)]

(1) Associated With

For an expenditure to be considered "associated with" the active conduct of the taxpayer's trade or business, the taxpayer must show that he had a clear business purpose in making the expenditure, such as to get new business or to encourage the continuation of an existing business relationship.[18)] However, any portion of an expenditure allocable to a person who was not closely connected with a person who engaged in the substantial and bona fide business discussion is not considered associated

13) Treas. Reg. § 1.274-2(c)(7)(i).

14) I.R.C. § 274(a)(1)(A).

15) *Supra* note 2.

16) Rev. Rul. 63-144(Question 21), 1963-2 C.B. 129.

17) *Supra* note 17.

18) Treas. Reg. § 1.274-2(d)(2).

with the active conduct of the taxpayer's trade or business.[19] The portion of an expenditure allocable to the spouse of a person who engaged in the discussion will, if it is otherwise allowable, be considered associated with the active conduct of the taxpayer's trade or business. [20]

(2) Substantial and Bona Fide Business Discussion

Whether any meeting, negotiation or discussion constitutes a "substantial and bona fide business discussion" depends upon the facts and circumstances of each case. The taxpayer must establish, however, that the taxpayer was actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining income or other specific trade or business benefit.[21] In addition, the taxpayer must establish that such a business meeting, negotiation, discussion, or transaction was substantial in relation to the entertainment.[22] This requirement will be satisfied if the principal character or aspect of the combined entertainment and business activity was the active conduct of business. However, it is not necessary that more time be devoted to business than to entertainment to meet this requirement.[23]

A meeting in connection with a program at a convention or similar assembly, or as part of a program at a bona fide trade or business meeting sponsored and conducted by a business or professional organization, is considered a substantial and bona fide business discussion if (i) the expense necessary to attend the event was ordinary and necessary within the meaning of I.R.C. § 162 or § 212, and (ii) the organization that sponsored the event scheduled a program of business activities (such as committee meetings, lectures, panel discussions, display of products, or other similar activities), and such program was the principal activity of the event.[24]

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19) *Id*.

20) *Id*.

21) Treas. Reg. § 1.274-2(d)(3)(i)(a).

22) *Id*.

23) *Id*.

24) Treas. Reg. § 1.274-2(d)(3)(i)(b).

(3) Directly Preceding or Following

Entertainment that occurs on the same day as a substantial and bona fide business discussion is considered to directly precede or follow such discussion.[25] If the entertainment and the business discussion do not occur on the same day, the facts and circumstances of each case are to be considered, including the place, date and duration of the business discussion, whether the taxpayer or his business associates are from out of town, and, if so, the date of arrival and departure, and the reasons why the entertainment did not take place on the day of the business discussion.[26] For example, if a group of business associates comes from out of town to the taxpayer's place of business to hold a substantial business discussion, the entertainment of such business guests and their wives on the evening prior to or on the evening of the day following, the business discussion would generally be regarded as directly preceding or following such discussion.[27]

3) Exceptions

Some situations do not require proof that an entertainment expense was "directly related to" and "associated with" the active conduct of the taxpayer's trade or business for that expenditure to be deductible. These specific exceptions include:[28] (i) food and beverages for employees on the taxpayer's premises; (ii) expenses treated as compensation; (iii) reimbursed expenses; (iv) recreational, etc., expenses for employees; (v) meetings of employees or stockholders, etc., business meetings; (vi) meetings of business leagues, etc.; (vii) items available to the public; (viii) entertainment sold to customers; (ix) expenses includible in income of nonemployees; and (x) certain otherwise available deductions.

2. Entertainment Facilities

Deductions for entertainment facilities are subject to even more severe

25) Treas. Reg. § 1.274-2(d)(3)(ii).

26) *Id*.

27) *Id*.

28) I.R.C. § 274(e).

restrictions than deductions for entertainment activities.[29] I.R.C. § 274 (a)(1)(B) provides that no deduction is allowed for an item paid or incurred with respect to a facility used in connection with an activity that is generally considered entertainment, amusement or recreation.[30] Even though some legitimate business expenses may be incurred with respect to entertainment facilities, such expenses will nevertheless be disallowed as business deductions to curb the significant opportunity for abuse that had existed under prior law.[31] Any use of such a facility, no matter how small, in connection with entertainment is fatal to the claimed deduction.[32]

Any item of personal or real property owned, rented or used by a taxpayer is considered to constitute a facility used in connection with entertainment if it is used during the taxable year for, or in connection with, entertainment.[33] For example, entertainment facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites, homes and vacation resorts.[34] [35]

Consequently, "expenditures with respect to a facility used in connection with entertainment" are not deductible. These expenditures include depreciation and operating costs, such as rent and utility charges (for example, water or electricity), expenses for the maintenance, preservation or protection of a facility (for example, repairs, painting, insurance charges), and salaries or expenses for subsistence paid to caretakers or watchmen.[36] However, tickets for sporting events, opera, theater, and similar amusements are not entertainment facilities regardless of whether the tickets are

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29) Boris I. Bittker et al., Federal Income Taxation of Individuals ¶ 13.03(6) (3d ed. 2003).

30) *See also* Treas. Reg. § 1.274-2(a)(2)(i).

31) **S. Rep. No. 95-1263** (1978), *reprinted in* 1978–3 C.B. (Vol. 1) 321, 472.

32) *See* Ireland v. Comm'r, 89 T.C. 978, 983 (1987); Gordon v. Comm'r, T.C. Memo. 1992-449(1992).

33) Treas. Reg. § 1.274-2(e)(2)(i).

34) *Id*.

35) *See* **Finney v. Comm'r, T.C. Memo. 1980-23** (1980)(Houseboats used to entertain business guests were entertainment facilities even though also used for sales promotion and to close sales.); Gordon v. Comm'r, *supra* note 32 (Boat used by operator of hull-cleaning and maintenance business to store equipment, books, and records and to entertain customers was entertainment facility.).

36) Treas. Reg. § 1.274-2(e)(3)(i).

purchased individually, in a series or by the season, or by an equivalent fee that entitles the taxpayer to use a seat, lounges, or boxes that provide a viewing area for such an event, and such costs are generally subject either to the provisions of the I.R.C. relating to entertainment activities or to those that govern the deductibility of business gifts.[37] [38]

Dues or fees to any social, athletic, or sporting club or organization are treated as items with respect to facilities.[39] However, if the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of trade or business, club dues are deductible as entertainment expenses.[40] A taxpayer is deemed to have established that a club is used primarily in furtherance of the taxpayer's trade or business if it is established that more than 50 percent of the total calendar days of use of the facility by the taxpayer during the taxable year were days of business use.[41]

In general, no deduction is otherwise allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.[42] The purposes and activities of a club, not its name, determine whether it is organized for business, pleasure, recreation, or other social purpose.[43] Clubs organized for business, pleasure, recreation, or other social purpose include any membership organization a principal purpose of which is to conduct entertainment activities for members of the organization or their guests or to provide members or their guests with access to entertainment facilities.[44] Clubs organized for business, pleasure, recreation, or other social purpose include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances

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37) Rev. Rul. 63-144 (Question 43), 1963-2 C.B. 129.

38) For further analysis and application regarding facility, *see* Mary E. Vandenack, *The Entertainment Facility Rules of Section 274 and Corporate-Owned Condominiums*, 9 Akron Tax J. 97 (1992).

39) I.R.C. § 274(a)(2)(A).

40) I.R.C. § 274(a)(2)(C).

41) Treas. Reg. § 1.274-2(e)(4)(iii).

42) I.R.C. § 274(a)(3); Treas. Reg. § 1.274-2(a)(2)(iii)(a).

43) Treas. Reg. § 1.274-2(a)(2)(iii)(a).

44) *Id*.

generally considered to be conducive to business discussion.[45]

3. Business Meals/Tickets

An expense for food or beverages is deductible only if it is not lavish or extravagant under the circumstances, and the taxpayer or an employee of the taxpayer is present at the furnishing of the meal.[46] I.R.C. § 162(a)(2) disallows deductions for certain lavish and extravagant travel expenses (including meals), and no deduction is allowed under I.R.C. § 274 for any food or beverage expense, unless that expense is not lavish or extravagant under the circumstances. This disallowance applies regardless of whether the expense is incurred while the taxpayer is away from home or whether incurred alone or in company.[47] An expense is not lavish or extravagant if it is reasonable considering the facts and circumstances, and expenses will not be disallowed just because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.[48] The requirement for deductibility that the taxpayer be present at the meal does not apply where an individual traveling away from home on business has a meal alone or with persons, such as family members, who are not business-connected, and the deduction is claimed only for the meal of the individual.[49] However, neither the lavish or extravagant limitation nor the taxpayer's presence requirement are applicable in the situations in which expenses are treated as compensation, reimbursed expenses, recreational expenses for employees, items available to the public, entertainment sold to customers, and expenses includible in income of people who are not employees.[50]

In determining the amount allowable as a deduction for any entertainment activity or facility, the amount taken into account cannot exceed the face value of the ticket.[51] However, the face value limitation does not apply to

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45) *Id*.

46) I.R.C. § 274(k)(1).

47) MERTENS, *supra* note 2, at § 25D: 52.

48) Rev. Rul. 63-144(Question 42), 1963-2 C.B. 129; *see also* Publication 463, p. 12 (Feb. 2012).

49) *Id*.

50) I.R.C. § 274(k)(2).

51) I.R.C. § 274 (l)(1)(A).

an expense for any ticket for any sports event that is organized for the primary purpose of benefiting an organization operated exclusively for religious, charitable, scientific, public safety, literary, or educational purposes, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.[52] In the case of a skybox or other private luxury box leased for more than one event, the deductible amount cannot exceed the amount equal to the face value of the non-luxury tickets multiplied by the number of seats in the box covered by the lease.[53]

4. Business Gifts

No deduction is allowed under I.R.C. § 162 or § 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25.[54] A gift is any item excludible from gross income of the recipient under § 102 that is not excludible from the recipient's gross income under any other income provision.[55] However, the following is not included as a business gift: (i) an item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer,[56] or (ii) a sign, display rack, or other promotional material to be used on the business premises of the recipient.[57]

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52) I.R.C. § 274 (l)(1)(B).

53) I.R.C. § 274 (l)(2).

54) I.R.C. § 274 (b)(1); Treas. Reg. § 1.274–3(a); *see* Leschke v. Comm'r, T.C. Memo. 2001-18 (2001) (Gift certificates claimed as deductible business expenses were deductible only to extent of $25 per certificate, absent establishing that gift certificates were given to undesignated and unknown members of a large group in sole discretion of the receiving entity.).

55) I.R.C. § 274 (b)(1).

56) I.R.C. § 274 (b)(1)(A).

57) I.R.C. § 274 (b)(1)(B).

5. 50 Percent Deductibility Rule

The amount of entertainment expenses otherwise deductible is limited. I.R.C. § 274(n) limits the deduction to 50 percent of the otherwise deductible amount. A special rule for individuals in the transportation industry, who are subject to federal hours-of-service requirements, permits a larger deduction of 80 percent for tax years beginning in 2008 and thereafter.[58] § 274(n) is based on the premise that business entertainment expenses have both a personal and a business element and that a reasonable bright-line rule is to treat such expenses as half personal (and thus nondeductible) and half business-related (and thus deductible).[59]

6. Substantiation Requirement Rule

For a taxpayer to deduct entertainment expenses, the taxpayer must substantiate by adequate records or by sufficient evidence corroborating the taxpayer's own statement on (i) the amount of such expense or other item, (ii) the time and place of the entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (iii) the business purpose of the expense, and (iv) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift.[60]

This rule superseded the Cohan rule, which provided that, if a taxpayer incurred deductible expenses but could not prove the exact amount,[61] the tax authorities had to make "as close an approximation as it could" rather than disallow the deduction entirely.[62]

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58) I.R.C. § 274(n)(3).

59) Boris I. Bittker et. al., *supra* note 29, at ¶ 13.03(4).

60) I.R.C. § 274(d). In addition to entertainment expense and gifts, § 274(d) imposes substantiation requirements on deductions and credits for (i) traveling expenses, including away-from-home meals and lodging, claimed under § 162 or § 212, and (ii) listed property, as defined by § 280F(d)(4).

61) Cohan v. Comm'r, 39 F2d 540, 543-544 (2d Cir. 1930).

62) Treas. Reg. § 1.274–5T(a); *see also* Sentinel Fin. Servs. v. Comm'r, T.C. Memo.1992–733, *aff'd*, without published opinion 39 F.3d 1188 (9th Cir.1994).

In applying the substantiation rules, each separate payment (e.g., for breakfast, lunch, and dinner) constitutes a separate expenditure,[63] but concurrent or repetitious payments during a single event (e.g., several rounds of drinks in a cocktail lounge) are treated as a single expenditure.[64]

Deemed Substantiation—Per Diem and Mileage Allowances

I.R.C. §274(d) and the applicable treasury regulations authorize the IRS to treat subsistence reimbursement arrangements, per diem allowances, and mileage allowances, "if in accordance with reasonable business practice," as equivalent to substantiation by adequate records for purposes of the basic substantiation requirements of § 274(d) and as satisfying the adequate accounting requirement in the case of employees accounting to employers.[65] Accordingly, the IRS pronounces per diem and automobile mileage allowances from time to time.[66] In these revenue procedures relating to per diem allowances, the deemed substantiation rule for meals applies to both employees and self-employed taxpayers, but the rule for lodging applies only to employees. Self-employed taxpayers must substantiate away-from-home lodging expenses in every event.[67]

III. Review and Analysis of the Relevant Provisions and Their Interpretation in Korea

Under Korean tax law, taxable income is calculated as gross income minus deductible expenses.[68] In terms of permissible tax expenses, one

63) Treas. Reg. § 1.274-5T(c); BORIS I. BITTKER ET. AL., *supra* note 45, at ¶ 13.05.

64) When an employee incurs expenses solely for the employer's benefit and charges them to the employer or receives advances or reimbursements to cover them, the employee is partly relieved of the § 274(d) substantiation burden, if an adequate accounting to the employer is required and made. *See* Treas. Reg. §§ 1.274-5(f)(4), 1.274–5T.

65) BORIS I. BITTKER ET. AL., *supra* note 29, at ¶ 13.05(06); Treas. Reg. §§ 1.274-5(g), 1.274-5(j).

66) In applying for the taxable year 2012, *see* Rev. Proc. 2011-47, 2011-42 I.R.B. 520 (per diem allowances); Rev. Proc. 2010-51, 2010-51 I.R.B. 883 (standard mileage rates).

67) Christian v. Comm'r, T.C. Memo. 2000–385; Duncan v. Comm'r, T.C. Memo. 2000–269.

68) CTL art. 14, first sentence.

general section, article 19 of the CTL, defines the conditions for deductible business expenses,[69] and the following other individual articles disallow otherwise deductible expenses in article 19. Thus, some expenses may not be deductible for tax policy. One of them is article 25 of the CTL, which defines meals and entertainment expenses and restrains the deductible amount.

1. Relationships between Articles 19 and 25 of the CTL

Article 19 of the CTL prescribes the concepts and scope of deductible business expenses as a general provision, and the following provisions, such as articles 19(2) through 28, prescribe non-deductible expenses. Entertainment expenses are prescribed in article 25. Thus, for a clear interpretation of the CTL, relationships between articles 19 and 25, that is, whether they are independent of or mutually related to each other should be clarified. If entertainment expenses are business expenses in nature, for a tax deduction, entertainment expenses must meet conditions prescribed in article 19 as well as article 25; but, if entertainment expenses are not business expenses in nature, it is enough that they meet only the conditions set out in article 25.

Article 25 of the CTL provides expenses in paragraph (1) a ceiling of the allowable entertainment, the substantiation requirement in paragraphs (2) and (3), and the definition of entertainment expenses in paragraph (5). Accordingly, under article 25, a certain expenditure that is classified as an entertainment expense is deductible, if it is substantiated and within the threshold amount during the taxable year. However, if the expenditure is not substantiated or the total expenditures during the taxable year are beyond the threshold amounts, the expenditure is not deductible. Thus, a question may arise whether the basis for admitting an entertainment expense as a deductible expense is article 19 or article 25. Provisions of articles 19(2) through 28, which are titled as non-deductible expenses, can be classified: (i) a certain expense does not deserve a deduction due to its nature, such as article 20 (non-deductible expenses as capital transactions);

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69) *See supra* Chapter 2. II.

(ii) some expenses are not deductible for a policy reason, such as bribery, which is prescribed in article 27; (iii) others are deductible but in limited scope, such as the disallowance of a deduction of a bad debt loss in article 19-2 and a depreciation disallowance in article 23; and still others are expenses that originally are not business expenses but are allowed a deduction for a policy reason, such as charitable contributions in article 24.

If article 25 is a provision that allows a deduction for an expense that is not deductible under article 19, like charitable contributions in article 24, the base that allows a deduction for an entertainment expense is article 25. Conversely, if an entertainment expense deserves a deduction as a business expense without article 25, the base that allows a deduction for an entertainment expense is article 19 of the CTL, while article 25 limits the amount of a business deduction for an entertainment expense for tax policy purposes.

A charitable contribution is allowed as a tax deduction within a certain scope as a matter of tax policy to encourage taxpayers to make such contributions even though they are not business expenses in nature. In contrast, if an entertainment expense is not a business expense in nature, there is no policy reason to allow a tax deduction for the entertainment expenditure, because it tends to mix together a business and a personal expense. Historically, article 25 was introduced to regulate entertainment related expenditures. Therefore, article 25 is not a base provision to allow a tax deduction for an entertainment expense; rather it is to regulate an entertainment expense. This means that an entertainment expense is fully deductible if there is no article 25.[70] [71]Accordingly, the basis for a tax

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70) The Supreme Court of Korea also ruled that an entertainment expense in nature is a deductible business expense as a payment made in relation to business operations. *See* Supreme Court Rulings, Judgment of Oct. 25, 2007, *2005Du8924*; Judgment of April 26, 1983, *80Nu527*. Supreme Court [S. Ct.], 2005Du8924, Oct. 25, 2007 (S. Kor); Supreme Court [S. Ct.], 80Nu527, Apr. 26, 1983 (S. Kor).

71) In Seungsoon Lim, Lecture on Taxation, 2008, 616 and in Taero Lee & Mansoo Han, Lecture on Taxation 422 (6th ed. 2009), the authors admit that an entertainment expense in nature is a deductible business expense, but Professor Lee disagrees with this opinion, *see* Changhee Lee, Lecture on Taxation 932 (7th ed. 2008). Seungsoon Lim, *Josebeob, [LECTURE ON TAXATION]*, 616 Bag-yeongsa (2008)(Korean), Taero Lee & Mansoo Han, *Josebeopgangui [Lecture on Taxation]*, 422 Bag-yeongsa (6th ed. 2009)(Korean).

deduction for an entertainment expense is article 19,[72] as the result of which a tax deduction for an entertainment expense must meet the conditions of both articles 19 and 25.

2. *Interpretation of Entertainment Expense Provisions and Their Scope in Application*

1) Statutory Provisions

As described above, one general section, article 19 of the CTL defines the conditions for deductible business expenses, and the following other individual articles disallow otherwise deductible expenses in article 19. Article 25, which prescribes an entertainment expense, is one of them. Paragraph 5 of article 25 defines an entertainment expense as entertaining or socializing expenditures or commissions, or similar expenditures spent by a taxpayer in connection with its business, regardless of how such expenditures are called.

2) Interpretation of Courts

The Korean Supreme Court has interpreted "entertainment expenses" as expenditures for which a corporation made a payment in doing business to persons related to its business to enhance a social relationship and to smooth a business transaction.[73] Combining the Court's interpretation with

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72) Article 19 of the CTL prescribes the scope of expenses and loss, and article 19 of the *Beopinse beob sihaeng ryeong*,Presidential Decree of the CTL Beob-inse beob sihaenglyeong [Enforcement Decree of Corporation Tax Act], Presidential Decree No. 23724, Apr. 13, 2012, *as amended* (S. Kor) illustrates items of deductible expenses. Article 19, no1-2 of the Presidential Decree illustrates sales incidental expenses. Regarding sales incidental expenses, article 10 of the *Beopinse beob sihaeng gyuchik*Enforcement Rules of the CTL: Beob-inse beob sihaeng gyuchik[Enforcement Rules of Corporation Tax Act], Ministry Decree No. 283, Apr. 19, 2012, *as amended* (S. Kor) provides that sales incidental expenses mean the same as those in the generally accepted accounting principles. Under the Korean Accounting Standard (KAS), an entertainment expense is classified as one of the sales and administrative expenses (Under the KAS, sales incidental expenses and administrative expenses are not recorded separately). Therefore, an entertainment expense may be a sales incidental expense according to its nature in spending. *See* Ch. 2.49 and its appendix Sil.2.47 of the Accounting Standard for Non-Public Entities. Ilban gi-eob hoegye gijun [Accounting Standards for Non-Public Entities], Korea Accounting Standard, Oct. 5, 2011.

73) Judgment of July 9, 2009, *2007Du10389* (Supreme Court of Korea); Judgment of July

article 25(5)'s definition of "entertainment expense" discussed above, whether a certain expenditure is an entertainment expense is not decided according to the amount spent, the place where the entertainment occurred, or the time period involved, but rather according to the characters, partners, or purposes of expenditures. In deciding whether a certain expenditure is an entertainment expense, the Supreme Court has not reached a conclusion after analyzing the elements of the concept of an entertainment expense. Instead, the Court has tended to decide whether a certain expenditure is an entertainment expense by contrasting or comparing other expenses, such as ordinary expenses, a sales incidental expense, or an advertising expense.

(1) Ordinary Expense v. Entertainment Expense

In Judgment of July 10, 2008, 2007Du26650 (Supreme Court of Korea), a taxpayer paid overtime overhead costs, such as meals or snacks, for a business partner's employees, who worked at the taxpayers' premises. The business partner was associated with the taxpayer to earn and accomplish service contracts from a third party. Under these circumstances, the Court held that the expenses for meals and snacks are not entertainment expenses, since they are ordinary business expenses.

However, to decide whether a certain expenditure is an entertainment expense with contrast an entertainment expense and an ordinary expense is persuasive only when articles 19 and 25 are independent of each other, and, in this case, an entertainment expense is decided merely based on article 25 without considering article 19, which demands ordinary requirements. But an entertainment expense also must satisfy conditions for ordinary expenses in article 19, since article 25 is not a base provision that allows a tax deduction for an entertainment expense.[74] Accordingly, the premise that if a certain expenditure is an ordinary expense it is not an entertainment expense is not correct. If a certain expenditure is not an ordinary expense, it

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10, 2008, *2006Du1098* (Supreme Court of Korea); Judgment of Oct., 25, 2007, *2005Du8924* (Supreme Court of Korea); Judgment of Dec., 12, 2003, *2003Du6559* (Supreme Court of Korea). Supreme Court [S. Ct.], 2007Du10389, July. 9, 2009 (S. Kor); Supreme Court [S. Ct.], 2006Du1098, July. 10, 2008 (S. Kor); Supreme Court [S. Ct.], 2005Du8924, Oct. 25, 2007 (S. Kor); Supreme Court [S. Ct.], 2003Du6559, Dec. 12, 2003 (S. Kor).

74) *See supra* II.1.

is not entitled to be a deductible expense at all even before considering whether it is an entertainment expense. Moreover, even though a certain expense is an ordinary expense, if it is classified as an entertainment expense, it must satisfy additional conditions described in article 25 for a business deduction. Therefore, the position of the Supreme Court that a certain expenditure is not an entertainment expense because it is an ordinary expense may be misleading.

(2) Sales Incidental Expense v. Entertainment Expense

The Korean Supreme Court often compares or contrasts sales incidental expenses and entertainment expenses to decide whether a certain expenditure is an entertainment expense. If a certain expenditure was made doing business with persons related to its business to enhance a social relationship and to smooth business transactions, the expenditure is an entertainment expense; but, if a certain expenditure is accepted as directly related and normal when considering reason, character, and the amount of spending together with a sound social norm or business practice, it is a sales incidental expense, which is fully deductible as a business expense.[75)]

In Supreme Court Ruling 2007Du12422, decided November 12, 2009, where a taxpayer, a corporation that imported and sold cigarettes, paid salaries of marketing and displaying personnel and other part-timers of sales agencies in lieu of sales agencies, and subsidized maintenance expenses of vehicles of sales agencies, the Court held that the payment for sales agencies is not an entertainment expense, since it is a sales incidental expense as a generally acceptable ordinary expense, which was paid for sales agencies to promote sales of products (cigarettes), where such payment was needed considering a special situation in the selling areas.

To decide whether a certain expenditure is an entertainment expense rather than an entertainment expense and a sales incidental expense is also

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75) *See* Judgment of Nov. 12, 2009, *2007Du12422* (Supreme Court of Korea); Judgment of July 9, 2009, *2007Du10389* (Supreme Court of Korea); Judgment of July 10, 2008, *2006Du1098* (Supreme Court of Korea); Judgment of Oct., 25, 2007, *2005Du8924* (Supreme Court of Korea); Judgment of Dec., 12, 2003, *2003Du6559* (Supreme Court of Korea). Supreme Court [S. Ct.], 2007Du12422, Nov. 12, 2009 (S. Kor); Supreme Court [S. Ct.], 2007Du10389, July. 9, 2009 (S. Kor); Supreme Court [S. Ct.], 2006Du1098, July. 10, 2008 (S. Kor), Supreme Court [S. Ct.], 2005Du8924, Oct. 25, 2007 (S. Kor); Supreme Court [S. Ct.], 2003Du6559, Dec.12, 2003 (S. Kor).

problematic. According to article 10 of the *Beopinse beob sihaeng gyuchik*, Enforcement Rules of the CTL, the meaning of a sales incidental expense should be interpreted consistently with its meaning in the generally accepted accounting principles. Under the GAAP, since a sales incidental expense is not required to be directly related to a sale, an entertainment expense may be classified as a sales incidental expense.[76] Thus, the conclusion that a certain expenditure is not an entertainment expense, since it is a sales incidental expense, may be misleading and the Court's rationale is not based on sound ground.

(3) Advertizing Expense v. Entertainment Expense

Sometimes the Supreme Court compares or contrasts advertizing expenses and entertainment expenses to decide whether a certain expenditure is an entertainment expense. If a certain expenditure was made doing business with persons related to its business to enhance a social relationship and to smooth business transactions, it is an entertainment expense. If, however, the expenditure was made to unspecified persons and intended to stimulate their desire to buy, it is an advertizing expense, which is deductible as a business expense without limitation.[77] So, according to the Court's ruling, the two threshold criteria between advertizing expenses and entertainment expenses are (i) whether the opposite parties of spending are specified and (ii) whether the purpose of the expenditures is to enhance a social relationship and to smooth business transactions or to stimulate the desire to buy.[78]

However, deciding the purpose of an entertainment expense, that is, whether the expenditure is intended to enhance a social relationship or to stimulate a purchase does not solve the problem at issue, because, in many cases, expenditures have mixed purposes to promote sales and to improve relationships. Further, the distinction between certain and uncertain

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76) *See* Ch. 2.49 and its appendix Sil.2.47 of Accounting Standard for Non-Public Entities.

77) *See* Supreme Court [S. Ct.], 2000 Du2990, Apr. 12, 2002 (S. Kor); Supreme Court [S. Ct.], 92Nu6249, Sep. 14, 1993 (S. Kor); Supreme Court [S. Ct.], 92Nu8293, Jan. 19, 1993 (S. Kor)

78) For further reference to comparative analysis of Court rulings regarding entertainment and advertising expenses, *See* Byeongmoon Jeong, *Distinction between entertainment expenses and advertising expenses under the CTL*, Interpretation of Court Rulings 263 (Vol. 41, 2002).

persons is also vague and therefore does not contribute to resolving the issue.

3) Interpretation of Administrative Agency

Generally, the Korean tax authorities have executed tax law related to entertainment expenses based on the vast majority of agency rulings, which are very often beyond delegated power, and some of them even contradict each other. The following refer to practices and problems with the agency's interpretations.

(1) Extension of the Meaning of Entertainment Expense - Reduction of the Meaning of Sales Incidental Expense

Article 10 of the Enforcement Rules of the CTL provides that the meaning of a sales incidental expense should be interpreted consistently with the meaning applied in the generally accepted accounting principles. Under the GAAP, a sales incidental expense is not required relate directly to sales.[79] However, tax authorities interpret a sales incidental expense as an expenditure that is directly related to sales of goods or merchandise and make a crucial contribution to the realization of revenue or is required to pay it, and that is recorded as a sales incidental expense according to the GAAP or to business practice. On the other hand, an entertainment expense is an expenditure that is not required to pay and is not related to the realization of revenue, but is paid to smooth transactional relationships in expectation of realization of revenue.[80] This position of the tax authorities regarding a sales incidental expense is narrower than the scope of meaning under the GAAP.[81]

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79) *Supra* note 76.

80) National Tax Service (NTS), *Corporation Tax Guidelines in Topics (Entertainment and Similar Expenses)*, 2003, p.17. Guksecheong (National Tax Service; NTS), *Corporation Tax Guidelines in Topics (Entertainment and Similar Expenses)* 17, 2003.

81) As described in *supra* II. 2. (2). (B), Rulings of the Supreme Court also interpreted the meaning of sales incidental expenses more narrowly than those of the GAAP, but the administrative agencies interpreted sales incidental expenses more narrowly than has the Court.

(2) Expenditure in Advance Agreement

The tax authorities consider a certain favorable treatment to customers as sales incidental expenses when the favorable treatment is paid in accordance with an advance agreement. When there is no advance agreement, the favorable treatment is considered an entertainment expense.[82] This position has no sound statutory basis. In addition, it is not clear why payment without an advance agreement is an entertainment expense while payment with an advance agreement is a sales incidental expense. Moreover, the concepts of "in advance" or "prior" in the context of an agreement are not clearly defined.

(3) Expenditure for Specified Persons or Customers

According to administrative rulings in many cases, for a certain expenditure to be a sales incidental expense, the expenditure should not be payment to an ascertainable person or customer. Thus, an incentive or discount given to only one or to limited customers is an entertainment expense.[83] Samples or gifts to limited customers are also an entertainment expense.[84]

However, to decide whether a certain expenditure is an entertainment expense based on payment to specified persons has some problems. There is no clear standard for specified persons and the conclusion that the expenditure for specified persons is an entertainment expense is not always accurate.

(4) An Entertainment Expense not Within the Connotation of an Entertainment Expense

Korean tax authorities have considered as entertainment expenses other expenses that by concept are not entertainment expenses. Two illustrations are the forgiveness of a debt owed by a third party[85] and the sale of an asset

82) NTS, Seomyeon 2 team-1591, 2007.8.31; NTS, Corporation-1386, 2009.12.8.

83) NTS, Corporation 46012-3407, 1998.11.10; Tax Tribunal, 2005Seo2047, 2006.9.1 (sales promotion expenditures); NTS, Corporation 46012-1484, 2000.7.3 (sales discount).

84) NTS, Corporation 46012-3435, 1999.9.4; NTS, Seomyeon 1 team-54, 2007.1.10.

85) Beopinse beob Gibontongchik [Fundamental Directives of Corporate Tax Law] 34-62-5.

to a third party at a below-market price.[86]

3. Substantiation

To deduct entertainment expenses over 10,000 Won (about $9) as business expenses, a taxpayer must maintain adequate documentary evidence of the entertainment expenses, with some exceptions as prescribed in the Beopinse beob sihaeng ryeong, Presidential Decree of the CTL.[87] Acceptable documents are receipts of credit cards and cash cards, a tax invoice under the Value Added Tax or the Income Tax Law, and some other receipts prescribed in the relevant law.[88]

4. Ceiling of Meals and Entertainment Expenses

Article 25(1) provides a maximum amount of deductible entertainment expenses as prescribed according to size and sales volume as follows:

> (i) Basic amount of 12,000,000 Won (about $10,000), but 18,000,000 Won (about $15,000) for small and medium sized corporations as prescribed in the Presidential Decree.
>
> (ii) The amount obtained by multiplying the revenue amount for the concerned taxable year by the rates under the following table. For revenue amounts earned from transactions with a related party prescribed under Article 52(1), the allowable amount is 20 percent of the amount otherwise allowable under the following table.

Revenue Amount	Rate
10,000,000,000 Won or less	20/10,000
More than10,000,000,000 Won Up to 50,000,000,000 Won	20,000,000 Won + (10/10,000 of the amount in excess of 10,000,000,000 Won
More than 50,000,000,000 Won	60,000,000 Won + (3/10,000 of the amount in excess of 50,000,000,000 Won)

86) NTS, Seomyeon 2 team-46012-11479, 2003.8.13.

87) *See* CTL §25(2),(3) (2011) and Enforcement Decree of CTL §41(1) (2012).

88) *Id.*

IV. Comparison of the Laws of the Unites States and Korea

I.R.C. § 274(a)(1) provides that no deduction otherwise allowable is allowed for any item with respect to an activity that is of a type generally considered to constitute entertainment, amusement, or recreation, unless a taxpayer establishes that the item was directly related to or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), was associated with the active conduct of the taxpayer's trade or business. "Entertainment" means any activity that is of the type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at nightclubs, theaters, clubs, sporting events, and on hunting, fishing, vacation and similar trips.[89)]

Paragraph 5 of article 25 of the CTL prescribes the meaning of entertainment expenses, defining "entertainment expenses" to mean entertaining or socializing expenditures or commissions, or similar expenditures spent by a taxpayer in connection with its business, regardless of how such expenditures are called. Thus, the United States and Korea have statutory provisions to deal with entertainment expenses. There are many regulations and cases. To have a business deduction, a taxpayer must not only meet the requirements set out in the provisions that apply to entertainment expenses, but also those set out in such general provisions as section 162(a) of the U.S. tax code and article 19 of the CTL. However, the contents of the provisions are different in the United States and Korea. The American provisions are more detailed and rigid than the comparable provisions in Korea.

1. Conditions for Deduction

Under I.R.C. § 274(a)(1)(A), a taxpayer must satisfy the business connection test, which requires that an entertainment expense be directly related to or at least associated with the active conduct of the taxpayer's

89) *Supra* note 4.

trade or business. This is a more stringent condition for a deduction than those required by I.R.C. § 162(a), a general provision for a business deduction. Thus, in the United States, if a certain expenditure is classified as an entertainment expense, it must endure a more rigid business connection test to be deductible. There are many regulations to supplement "directly related to" and "associated with."[90] On the other hand, article 25(5) of the CTL of Korea merely defines "entertainment expense" as entertaining or socializing expenditures or commissions or similar expenditures spent by a taxpayer in connection with its business, regardless of how such expenditure are called. Article 25 and other provisions do not demand stricter conditions for an entertainment expense to be deductible as compared to the conditions set out in article 19, a general provision for a business deduction. This is because Korea regulates entertainment expenses according to the amount paid and does not impose rigid conditions to be met for a deduction. *infra*.

In the United States, the deduction of an entertainment expense must meet the "directly related" test, which requires that the expenditure survive (i) the active business discussion test or (ii) the clear business setting test. A general expectation of deriving some income or the goodwill of the person(s) entertained at some indefinite future time is not enough to meet this test. In Korea, however, there is no such rule. Of course, in the United States, an expenditure to increase good will or with the expectation of income may be deductible if the expenditure is associated with the trade or business, and the expenditure incurred directly preceded or followed a substantial and bona fide business discussion.[91] Under Korean tax law, an entertainment expense for good will may also be deductible. But Korea does not require that business be discussed during, before or after entertainment, and Korea has no detailed provisions on this matter such as those in the United States. Usually Korea applies a comparative analysis with other expenses when a taxpayer claims that an expenditure is an entertainment expense. For example, the Korean Supreme Court and tax authorities consider whether an expense is an ordinary expense or an entertainment expense; sales incidental expense or entertainment expense;

90) *See supra* I.1.

91) *See supra* I.1. (2).

advertizing expense or entertainment expense; expenditure in accordance with an advance agreement; or expenditure for specified persons. But this practice in Korea has not given a clear interpretative guideline for entertainment expenses at issue while leaving much discretion to administrative agencies to interpret this matter beyond their delegated power.

2. Entertainment Facilities

In the United States, deductions for entertainment facilities are subject to even more severe restrictions than deductions for entertainment activities. In general, no deduction is allowed for an expenditure paid or incurred with respect to a facility used in connection with an activity generally considered entertainment, amusement or recreation, such as yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, and vacation resorts. Dues or fees to any social, athletic, or sporting club or organization are treated as items with respect to facilities.[92] But tickets for sporting events, opera, theater, and similar amusements are not entertainment facilities.[93] In contrast, Korea does not have such a rule, as the result of which expenditures for or in connection with entertainment facilities may be deductible if they meet other conditions. For example, in Korea, maintenance fees for a vacation home or golf club dues may be deductible.

3. Business Meals/Tickets/Skyboxes

In the United States, an expense for food or beverages is deductible only if it is not lavish or extravagant under the circumstances and a taxpayer or an employee of the taxpayer is present at the furnishing of the meal. Only the face value of a ticket is deductible, and the deductible amount of a skybox cannot exceed the amount equal to the face value of the non-luxury tickets multiplied by the number of seats in the box. In Korea, there is no such limitation.

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92) *See supra* I.2.

93) *Supra* note 37, 38.

4. Business Gifts

In the United States, no deduction is allowed for any expense of gifts in excess of $25 per recipient during a taxable year. A gift is any item excludible from the gross income of the recipient under I.R.C. §102 that is not excludible from the recipient's gross income under any other income provision. But in Korea, a business gift is considered together with the total entertainment expenses without separating it from entertainment expenses and with no maximum limitation per recipient.

5. Ceiling of Meals and Entertainment Expense

In the United States, the amount of an entertainment expense otherwise deductible is limited to 50 percent of the otherwise deductible amount. Korea also has an allowable amount limitation, which is more complex than that of the United States, which has been set out in section II.4. above.

6. Substantiation Requirement

Both countries require a taxpayer to substantiate entertainment expenses for a deduction. Under American tax law, to deduct entertainment expenses, the taxpayer must substantiate by adequate records or by sufficient evidence corroborating the taxpayer's own statement on (i) the amount of such expense; (ii) the time and place of the entertainment; (iii) the business purpose of the expense; and (iv) the business relationship to the taxpayer of persons entertained. Under Korean law, to deduct entertainment expenses as business expenses, the taxpayer must maintain adequate documentary evidence for expenditures over 10,000 Won (about $9) with some exceptions as prescribed in the Presidential Decree of the CTL. Acceptable documents are receipts of credit cards, cash cards, tax invoices under the Value Added Tax or the Income Tax Law, and some other receipts prescribed in the relevant law. In contrast to American tax law, however, Korea does not admit evidence corroborating the taxpayer's own statement. In the United States, as an alternative of documented substantiation, information such as per diem and mileage allowances may

be accepted as deemed substantiation if some conditions are met. Korea does not have this kind of deemed substantiation rule.

V. Conclusion

For a business deduction of entertainment related expenditures, the expenditure must meet not only the requirements for entertainment expenses, but also the requirements for such general provisions as I.R.C. §162(a) and article 19 of the CTL. I.R.C. §274 and article 25 of the CTL provide additional conditions for a deduction of an entertainment expense. However, comparatively, the United States has more detailed and rigid provisions than Korea.

Unlike the United States, Korea regulates entertainment expenses only by placing a ceiling on the deductible amount, not by imposing arduous conditions for obtaining the deduction. To determine which expenses qualify as entertainment expenses, Korean courts or administrative agencies apply a comparative analysis with other expenses. Consequently, government agencies interpret and apply tax law broadly.

In the United States, no deduction is allowed for an expenditure paid or incurred with respect to a facility used in connection with an activity generally considered entertainment, amusement or recreation or dues or fees to any social, athletic, or sporting club or organization. But Korean tax law does not provide this kind of rule. In Korea, even the maintenance fees for a vacation home or golf club dues may be deductible, provided that other conditions are met.

The U.S. tax code requires the disallowance of expenses for gifts in excess of $25 per recipient during the taxable year. But in Korea, a business gift is considered together with total entertainment expenses without restricting maximum amounts. Thus, in Korea a business gift may be used as media for bribe or illegal commissions.

In the United States, 50 percent of any entertainment expense otherwise deductible is allowed. Korea also restricts otherwise deductible entertainment expenses according to a mathematical formula.

In both countries a taxpayer must comply with substantiate rules for a deduction of entertainment expenses. But unlike tax law in the United

States, Korea does not admit evidence corroborating the taxpayer's own statement. In the United States, as an alternative to substantiation, deemed substantiation, such as per diem and mileage allowances, may be acceptable. Korea does not adopt such deemed substantiation alternative.